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CREDIT AVAILABILITY

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

ON

THE AVAILABILITY OF CREDIT IN OUR ECONOMY AND TO TRY TO DETERMINE WHETHER OR NOT THERE IS CURRENTLY A CREDIT CRUNCH

JUNE 21, 1990

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CREDIT AVAILABILITY

THURSDAY, JUNE 21, 1990

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met, pursuant to notice, at 9:45 a.m., in room SD-538 of the Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

Present: Senators Riegle, Shelby, Heinz, Dixon, Garn, Kerry, Sarbanes, Mack, Wirth, and Dodd.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The CHAIRMAN. The committee will come to order. Let me welcome all of those in attendance this morning.

We have a number of important witnesses to hear from. We will start with our House colleague, Senator Joe Kennedy, from Massachusetts. I want to make a couple of announcements beforehand, one that I'm saddened to make.

FDIC Chairman, Bill Seidman, will not be present this morning because he was injured in a horse riding accident in New Mexico. That he is recovering is the good news.

I have a statement from the FDIC which I will read into the record verbatim.

> Federal Deposit Insurance Corporation Chairman, L. William Seidman, is in satisfactory condition following surgery Wednesday evening at a Santa Fe, New Mexico hospital for injuries suffered in a horse riding accident. The accident occurred at Mr. Seidman's New Mexico ranch where he was making an overnight visit before returning to Washington following two speaking engagements in Santa Fe. He underwent surgery last Wednesday to repair a separated pelvis. Mr. Seidman's doctors report that the surgery was successful. Mr. Seidman was in New Mexico to give a speech to the New Mexico Bankers' Association and to participate in an FDIC Management Conference in Santa Fe.

I have spoken with his office and his secretary this morning, their reports are positive; the operation was successful. While this is a painful problem to have, he seems to be coming along well.

I conveyed the sympathies and the best wishes of everyone on the committee to him. I am very sorry to report his absence and the reason for it.

Today the committee is holding hearings on the availability of credit and is asking whether or not there is a credit crunch.

We are in session this morning and there is a bill on the floor. So members will be coming and going. I will postpone opening statements until more members are present shortly.

Without further comment, let me welcome our House colleague Senator Kennedy.

Senator KERRY. It's an early promotion. [Laughter.]

Congressman KENNEDY. I don't think Teddy would necessarily be too happy with that, Senator.

The CHAIRMAN. Well, I heard John make the remark. [Laughter.]

Senator KERRY. I invited him to speak here. [Laughter.]

Congressman KENNEDY. Maybe that was a mistake. [Laughter.]

The CHAIRMAN. Senator Kerry has been instrumental in seeking this hearing this morning on this broad topic.

Senator SARBANES. We do the opening statements after we hear from the Congressman?

The CHAIRMAN. Yes.

Senator GARN. Mr. Chairman, I had no intentions of wasting everybody's time with my statement anyway. So, I would ask that unanimous consent that my statement be placed in the record and not wait for anybody.

The CHAIRMAN. Very good. It will be done along with Senators Dixon and Sanford.

Senator GARN. Thank you.

[Statements of Senators Garn, Dixon, and Sanford follow:]

STATEMENT OF SENATOR GARN

Senator GARN. I sometimes wonder what our constituents must think when they observe one of the hearings before this committee. On one day, they may hear us talking about nonbank banks, on another, nonthrift thrifts. I notice that you don't hear savings and loans called "thrifts" as often you used to. Added to this list, now we hear of nonperforming performing loans.

In this land of double speak, we are told by one that it is terrible if the value of the dollar goes up, while another calls it awful if it goes down. We hear the same thing about interest rates.

Then we come to bank regulation. When a regulator fails to classify a loan, he is being too soft, too sympathetic to the industry. When he says a loan looks bad, he is coming down too hard, creating a credit crunch.

It is difficult in this environment to find reality. I am pleased to have such a distinguished panel before us this morning to help us in this search for reality. We are privileged to have as our chief banking regulators men of wide and detailed experience, both in Government and in the private sector.

When it comes to questions of credit, we need to get down to the facts, to disperse the fog of hysteria that can blur our vision. I recall that a minor operation is one that is not happening to you. The same is true with credit. A person who cannot get a loan is experiencing a credit crunch. The question, though, is whether that person should be having that experience. The sick patient with an appendicitis should have the operation, minor or not. A person who is a poor credit risk probably should experience what he might call a credit crunch.

On the other hand, banking is a business, in many ways like any other business. Businesses can be subject to fads and fashions. At times, it seems, certain types of lending are popular, despite objective facts that might suggest caution. Lending to Third World governments 10 years ago was like that. At other times, certain classes of lending are shunned, despite objective facts that might suggest that profitable, prudent business may be conducted. Export credits and small business lending from time to time have fallen into this category.

I have an open mind on the question of the availability of credit today. Perhaps some of the measures taken by Congress, by the regulators, by lending institutions one way or another have made credit less available than it should be. If that is the case, it should be addressed. I feel that there are problems, for example, in the area of lender liability, particularly with regard to environmental impact, that must be resolved. I have introduced legislation to deal with this problem. It would be of interest to this Senator to hear what the witnesses have to say about these issues in general and this legislation in particular.

STATEMENT OF SENATOR DIXON

Senator Dixon. Mr. Chairman, I am pleased to be here this morning as the committee hears from the Chairman of the Federal Reserve Board, Alan Greenspan, my good friend, Bill Seidman, the Chairman of the FDIC, Timothy Ryan, the Director of the Office of Thrift Supervision, and Bob Clarke, the Comptroller of the Currency on the issue of whether or not there is a credit crunch going on at the moment. I look forward to hearing the views of these distinguished witnesses on this issue.

I confess that I am not sure whether there is a credit crunch underway or not. I have heard from a lot of my constituents, particularly homebuilders, suggesting that they have begun having a great deal of difficulty lately in obtaining credit. On the other hand, I have seen the aggregate lending figures that seem to indicate that, nationally, at least, there is no credit crunch.

I am, however, sure of one thing—we want to avoid, at all costs, any action that might be misinterpreted as encouraging banks to make imprudent loans. We ought not to lose sight of the fact that the aggregate amount of bad loans outstanding has been steadily increasing for a very long time now. I want banks to make loans, but I want them to be sound loans, loans that can be repaid based on the income of the individual borrower or the income of the business. What I think banks have to put a stop to is "Trump style" loans—loans made in the belief that the value of the property will go up, instead of any belief that the borrower can actually afford to pay off the loan if the property is not promptly resold. That kind of high-risk lending has no place in banking. Making loans in excess of the borrower's ability to repay is a recipe for disaster.

We will be examining questions related to examination practices and to regional variations in our economy. These issues are worth our careful attention. Given the fact that Federal deposit insurance stands behind our banking system, however, we also need to be continually vigilant to ensure that any unsound lending practices are promptly reined in by the regulators. The regulators have a tough job to do, and they deserve our backing.

OPENING STATEMENT OF SENATOR SANFORD

Senator **Sanford**. Thank you, Mr. Chairman, and I would like to thank our very distinguished panel of witnesses for appearing here this morning to testify about a subject of extreme importance. Those of us who lived through the days remember the tremendous economic problems that resulted from the credit crunches of the past—not just the Depression—but the shortages of funds we experienced in the mid 1960's, the late 1960's and the mid 1970's as well.

All of us are concerned that we may be starting down that road again, when shortages of funds and tight credit lead to serious national recessions. It is a road we clearly do not want to go down again, and one which we must turn away from now if we can.

Much of the data and testimony that has been presented to this committee suggests that the credit crunch, if we are indeed experiencing one, is centered in New England with pockets of credit tightening elsewhere in the country. But I can assure members of this committee that it is beginning to touch States such as my own, at least in a number of specific cases reported to me, despite the fact that North Carolina's economy remains strong, that we have experienced comparatively very few S&L failures and no bank failures in recent years. I am very troubled by the incidents of credit denials that have been reported to me.

I hope that we can explore this morning whether these instances of credit tightening are the result of lower demand for credit, which may suggest the beginning of a recession, or the result in supply constraints because our banks, thrifts and other institutions are more reluctant to lend. If the problem is a supply problem, then I think we need to study closely why our institutions are becoming more tight fisted.

I think the last message this Congress or this administration should be sending is one that urges bankers to make bad or imprudent loans, as that will only cost the Government and the taxpayers much more in losses down the road. Some additional caution on the part of banks, particularly with respect to real estate lending, is quite normal and prudent, but we need to be careful not to unduly exacerbate prudential caution with new regulations.

I understand the difficult position the regulators are in—trying to balance the need to establish and enforce tough enough lending standards to guard against bank failures while at the time encouraging the continuation of sound lending. I commend the regulators for their efforts to strike that balance and for their work in maintaining an open dialog with the lending community.

Again, I appreciate the willingness of our witnesses to be with me this morning, and I look forward to their testimony.

The **Chairman**. Senator Kennedy, we are delighted to have you today and we know that——

[Laughter.]

The **Chairman**. I have promoted you again.

Congressman **Kennedy**. That's fine with me, Senator. [Laughter.]

The **Chairman**. Congressman, we are pleased to have you here. And, we know that your State in particular is experiencing difficulties at the present time.

We would like to hear from you. When you have finished, we will give our opening statements.

Senator Kennedy.

STATEMENT OF CONGRESSMAN JOSEPH P. KENNEDY II, U.S. HOUSE OF REPRESENTATIVES, EIGHTH DISTRICT, MASSACHUSETTS

Congressman KENNEDY. Thank you, Mr. Chairman. First of all, let me thank you, Mr. Chairman, for agreeing to have these hearings.

I am very concerned that the experiences that Massachusetts has had to go through will now be felt by many other regions of the country. And, so I do think that it is very, very appropriate that you have shown leadership on this issue, as you have on other of the important banking issues that our country faces, particularly the FIRREA legislation that I think goes a long way under your leadership toward cleaning up the savings and loans in this country.

And, I just want to commend you on the work that you have done in that area.

And, I also want to take an opportunity to thank Senator Kerry, who has really shown tremendous leadership on the credit crunch issue up in New England. Senator Kerry was one of the first elected representatives to speak about the issue of credit I think in exchange perhaps in this committee with Chairman Greenspan some several months ago.

He really I think took the initiatives to talk about the problems that ordinary working families were going to be facing up in Massachusetts as a result of the drying up of credit. So, I want to thank Senator Kerry for his leadership, and he has done a terrific job all the way along for the people in our State.

Mr. Chairman, I can think of few issues more deserving of congressional oversight than the credit crunch that now afflicts the Northeast, and it threatens other parts of our country. It may not rival drug abuse, crime or homelessness as a social problem. But it can just as easily dash the hopes of working men and women who seek economic security in our country.

Credit is the sunlight of economic growth. A business requires credit as much as a seed requires the energy of the sun.

Without it, new businesses cannot start and existing businesses cannot expand. Some of Massachusetts' largest employers might be tiny storefront operations if banks couldn't supply the seed money to help them grow.

Unfortunately, the ready credit that fueled the Massachusetts miracle has been in short supply. Federal Reserve analysts told me recently that lending in the first quarter of 1990 at New England's large banks is down 3.7 percent from the fourth quarter of 1989, from $45.7 billion to $44 billion annually.

Lending for the second quarter of this year is expected to be a full 7 percent less, down to $42.4 billion. And, the Fed forecasts a continued credit drought for the rest of the year.

Lending in the fourth quarter could be as much as 14 percent less than the fourth quarter of 1989. That represents over $6 billion less money available for business growth and expansion.

These figures are backed up by other reports of a credit shortfall. A recent analysis by Shearson Lehman reported that with rare exceptions, commercial banks in New England are not making loans.

Dozens of businesses have contacted my office and the offices of other Congressmen and Senators to say that the credit shortage is their number one problem. The Massachusetts Governor's Office has received hundreds of phone calls from firms that can't find a bank willing to lend them money.

And, as the Massachusetts Industrial Finance Agency revealed recently, about one in four businesses that responded to a survey have had existing lines of credit capped, suspended, or switched from revolving to fixed lines.

As you well know, Mr. Chairman, healthy lines of credit are the life-blood of our businesses. Without them, businesses have a tough time meeting the payrolls or paying creditors. That can spell disaster for the company, for its workers and for the growth of the community.

So, the credit crunch is real. And, it is having a serious impact on our region.

Even Secretaries Mosbacher and Kemp now recognize that times are tough. At the same time, there is some disagreement about just what is causing this financial gridlock.

A general economic slowdown, spurred by the rapid decline in the real estate market, is largely to blame. The high-flying days of the mid-1980's are over, plain and simple. A new era of tighter belts and tougher regulatory oversight is necessary to restore equilibrium even if some institutions might suffer.

The real disagreement is over the role of the Federal bank regulators. Many bankers and people in the business community say that while regulators may not have caused the economic downturn they sure have greased the pole.

After being burned in the Southwest, regulators are now reportedly going too far in an effort to be tough. The result is that credit for our economy is in short supply because: No. 1, banks have been required to reserve an excessive amount of cash against loan losses, and No. 2, regulatory actions have sowed confusion and apprehension in financial markets, thus prompting overly cautious lending practices.

The savings and loan crisis reminds us all of the perils of hands-off regulatory policies. No one is trying to tell the regulators how to do their jobs.

With real estate depreciating by up to 25 percent in the Northeast, no one denies the need for tougher regulatory action. And, no one is advocating on behalf of specific banks.

I care about the safety and soundness of banks as much as anyone. But, one can scrutinize the regulatory practices without advocating forbearance.

In an effort to come to grips with this problem, I have tested the views of business people and bankers against the views of the experts. I have brought their concerns to the open doors of our top

Federal regulators, including Chairman Greenspan, Comptroller Clarke and Chairman Seidman, most of whom are here today.

I have held a forum so regulators in the Northeast could hear straight from the people who say that regulatory policies are hurting them. And, I met directly with New England's top bank and thrift regulators to learn what steps they are taking to strike a proper balance between making credit available and enforcing safe and sound business practices.

Based on these efforts, a few observations come to mind. First, amidst the sound and the fury about the role of the regulators, the impact of the underlying economic factors on the Northeast economy cannot be forgotten.

The economy is sufficiently diverse and dynamic that it can bounce back from its present lethargy. But, until the budget deficits are brought under control, until municipal bond ratings are restored, and until the demand for real estate catches up with the supply, the sluggishness and inertia will continue.

Blaming regulators is not the solution to the region's problems.

Second, it is difficult to sort out to what extent, if any, regulators have exacerbated the crunch. Certainly, a lot of their actions are not just understandable but welcome.

Many lenders, in their zeal to grab a piece of the hot real estate market, slackened off on underwriting standards and management practices. It's time for them to shape up.

However, there are clear signs that regulators have acted with unprecedented and unannounced toughness, despite the statements to the contrary. They may not have changed the rules, but they are applying them more rigorously than ever before.

William Isaac, former Chairman of the FDIC, says that the burden of proof has shifted the examiners to the bankers, who must now either document that a loan is healthy or mark it down even though the borrower is current on interest and principle payments.

Other troubling trends confirmed at my recent meeting with the New England regulators include that examiners are trying to project how loans will perform in the future instead of writing them down to what today's market says they are worth. The resulting confusion and caution is multiplied by the fact that regulatory agencies use different sets of assumptions.

The lack of coordination amongst these agencies has caused the troubling situation where one institution's stock drops more steeply than another's even though they have similar portfolios, just because one regulator uses a different set of assumptions than another.

Northeast banks have been treated more harshly than others. When the Southwest's economy bottomed out a few years ago, regulators weren't nearly as harsh on lenders even though Texas in 1986 was in far worse shape than New England is today.

And, for years regulators have let money center banks reserve only 35 to 40 percent of the value of shaky loans to highly indebted nations. That's far less than the 77 percent that one New England bank has been recently told to set aside against its troubled loans.

It's no wonder that the Shearson Lehman study found that exams in the Northeast are unprecedented in their rigor and warned of "a credit crunch induced by regulatory pressures."

I think the lenders could live with this new toughness if regulators told them that they had learned a few things since the S&L scandal. But, to deny that the regulatory pressures are tougher than ever before only generates confusion and excessive caution amongst banks and businesses.

Such denials needlessly restrict the availability of credit. After all, what bank would want to lend knowing that a loan may have to be reclassified as nonperforming even though its interest and principle payments are up to date?

And, what business would venture to undertake an expansion program knowing that a revolving line of credit might be wiped out at any moment?

Mr. Chairman, the causes of the credit crunch are complex. Solutions will not be found overnight.

A good first step I think is a hearing like this, or meetings like the ones that I have convened in Boston. These kinds of forums don't just allow people to blow off steam. But, more importantly, they allow the bankers, regulators and business people to replace adversarial posturing with constructive dialog.

Candid exchanges will help eliminate confusion and dampen the swing of the regulatory pendulum if, in fact, it has swung too far in the direction of toughness.

Mr. Chairman, there is evidence that the kind of hard work that has begun in the Northeast will reap benefits. In the last few days, the President of the Boston Fed has informed my office of substantial improvement in the availability of credit to small and medium-sized businesses.

His diagnosis has been seconded by the businesses and banking leaders of New England. Nevertheless, there is still cause for concern and not just in the Northeast but in other regions which are now beginning to feel the credit pinch.

The larger issue that faces the policy makers here in Washington is how much risk we are willing to let the banks take. After the savings and loans catastrophe, it's easy to understand the urge to minimize risk by toughening up regulatory oversight.

But, a certain amount of risk is essential to the success of our capitalist system. For that system to create wealth, lenders must make judgments—judgments about markets, judgments about potential borrowers—and take risks based on those judgments consistent with safe and sound banking practices.

If the regulatory pressures are so stiff that a lender can't invest in a promising new biotechnology firm, or in an expanding computer software firm, then an opportunity for growth is lost.

Our country can easily have a risk-free banking systems and no banks will fail. But, the cure would be worse than the disease.

A banking system without risk will spawn an economy without life. If America is to provide for the material needs of all of her citizens, then we must ensure that our economy is not needlessly shackled.

Thank you very much, Mr. Chairman.

The **Chairman**. Congressman Kennedy, let me just say that we appreciate that very thoughtful statement from you.

Let me make a personal observation, the office here, the physical office, in the Dirksen Building that I occupy is the one that your father had when he served as a U.S. Senator. Your father and your two uncles have served here—one still is now serving—So it is very natural to welcome any Member of Congress named Kennedy as Senator.

I appreciate your testimony today; and, I know my colleagues feel the same way.

Senator Kerry, did you want to make any comment?

Senator **Kerry**. I just want to thank Joe, first of all, for his kind comments. But, second, for his leadership on this issue which has really been most important.

We are truly hurting in Massachusetts, and I will say more about that later. But, Joe, as my counterpart on the Banking Committee in the House, has been right there and I think has really articulated the relationship as it affects every aspect of our economy in the State right now.

And, we've got to do something. I think that is his message.

And, I appreciate his coming here enormously.

Congressman **Kennedy**. Well, thank you very much, John. Senator, thank you for your time. Members of the committee, thank you very much.

And, I still appreciate the promotion. Take good care.

The **Chairman**. Thank you. Let me now invite to the table the following witnesses: Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve; Mr. Paul Fritts, who is the Director of the Division of Enforcement at the FDIC, who is here in place of Bill Seidman; Robert Clarke who serves as the Comptroller of the Currency; and, Timothy Ryan, who is the Director of the Office of Thrift Supervision.

Let me welcome all of our witnesses. I will make a brief opening comment to set the stage for this morning's hearings. Then I will call on my colleagues for their opening comments.

The central purpose of our hearing today is to examine the availability of credit in our economy and to determine whether or not there is currently a credit crunch. This morning, we will hear from the chief regulators, responsible in this area.

This afternoon, in a second and companion hearing, we will hear from some interested parties in the private sector.

The topic for this hearing was suggested by Senators Heinz, Dodd, Kerry, and D'Amato, who together sent a letter to me. In that letter they said, and I quote:

> There have been serious concerns raised over whether bank examination practices are exacerbating the problem by causing banks to restrict, or choke-off, real estate credit.

Other colleagues share these concerns. We look forward to this morning's panelists addressing this question.

Just last week during our hearings on export promotion and competitiveness, Secretary Mosbacher was seated at this table. I asked him his views on whether we are experiencing a credit crunch. His response was an unequivocal "yes."

He went on to say—and I quote from his testimony.

> I'm not convinced yet where the blame is, what the specific problem is. But I am convinced, yes, that there is one namely a credit crunch.

On the other hand, many experts believe that any contraction now occurring is market-driven and results from a slackening demand for real estate after years of rapid growth in real estate lending.

Federal Reserve Governor John LaWare put it this way, speaking of conditions in Massachusetts, and I quote Mr. LaWare.

> For a decade, the growth and prosperity of the Commonwealth were the envy of the rest of the country. We were on a roll and it didn't look like we would ever stop. Although the posted speed limit on the Mass Pike is 55, most of the traffic whirls along at 65 to 70. After you've been traveling with the crowd well over the limit, if you have to slow down there's a sense of disappointment and frustration.

There, of course, are many people who would share his point of view.

On October 5, 1989, analysts from the private sector testified before this committee on the condition of the banking industry. One of the risk factors they noted was the extraordinary growth in real estate lending in the Northeast over the past 5 years.

They warned that a policy of forbearance by the regulators could cause a replay of the savings and loan situation.

So, as we begin today's hearings, one trend seems clear: Demand for real estate has already softened or is in the process of slowing in many States throughout the country. Chairman Seidman, although not here, in his written testimony makes this point clearly. We will want to examine the implications of this slowdown carefully with our witnesses and ask whether or not it is spreading across the country.

There are very important implications here for the Federal insurance funds under the FDIC. In addition, softening real estate will make it more difficult to dispose of the assets taken from failed thrifts and now held by the RTC.

We will examine with the regulators their supervision over bank lending in the current environment; their supervision in the past; and what it should be in the future.

Striking a balance between sound supervision, regulation, and monetary policy is a difficult task. Its complexity is appreciated by this committee. Clearly, it is important to achieve a balance between those objectives.

The panelists this morning are the ones whose job it is to strike that balance. So we very much look forward to hearing from them.

Senator Garn?

Senator **Garn**. Mr. Chairman, I have put my formal statement in the record to save time. But, I would just echo what you have said about balance, that we be very, very careful and very cautious about what we do in interfering with the regulatory process.

I don't have to have a very long memory to sit back and recall in the early and mid-1980's, all the phone calls that came in from all over this country. And, it has become a very dirty word, "forbearance."

And, we talked about that anecdotal information and the incredible pressure to let these institutions grow out of it. Don't squeeze them down too much. Just give them a chance to grow.

We are bearing the fruit of those mistakes of having all of that end up and being a major part of the problem of the S&L crisis.

And, so once again each of us—and I've mentioned in previous hearings about all the anecdotal information about what the regulators are doing in the credit crunch and how difficult it is. Well, I think the most important thing I can say is let's be careful.

You don't have to have a long memory to remember when we went through this before. And, so I, of all people, do not want to slow down growth in my State or anyplace else in this country. And, I don't want unnecessary restricting of credit.

And, I could give you some examples I've given in previous hearings. It made no sense at all for an individual bank to turn down a loan or to call in performing loans that are in good shape.

But, on the other hand, to rush and suddenly say to the regulators, "You are all being too tough," doesn't make much sense when the vast majority of the criticism over the last year or so has been that they haven't been tough enough.

So, again, I say let's be very, very careful about what we do in this area. This Senator, if he has to err, will err on the side of tougher regulation.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Sarbanes.

OPENING STATEMENT OF SENATOR SARBANES

Senator SARBANES. Thank you very much, Mr. Chairman. First of all, I want to commend you for holding this hearing this morning and also this afternoon on a very important issue.

I must say to the members of the panel, I'm very much concerned about the difference in perspective that seems to be at work here. And, obviously there is a fine line that has to be walked.

But, there seems to be a difference as the regulators enunciate what they are doing and as the industry states what they perceive as being done, so much so that apparently there was, at least as the press reports it, an unprecedented meeting by all of the regulators with the ABA to discuss what is taking place. And, there was a comment after that meeting that said, "The implication of the meeting was that they, the regulators, were concerned about misconceptions by bankers who viewed the tougher bank examinations as a sign the Government was trying to discourage them from making certain kinds of loans."

And, Chairman Greenspan said, at least in this story, "Acknowledged that concerns were being expressed by bankers and other business executives that a reduction in lending could be slowing the economy."

"When you look at the total system," Chairman Greenspan said, "the evidence of that is quite limited.

Of course, the total system is not the full story. I mean, you may have regional problems of great severity. That's one of the things that we have been hearing, including in my own region a sort of unprecedented action by the Greater Washington Board of Trade in terms of communicating with the administration about their concern that there is, in effect, a credit crunch that has been imposed and their fear that, you know, they may find themselves, in a sense, prompted into a downturn.

I'm trying hard to understand this difference in perception. And, I think it's important to try to get that out of the panel this morning, because you hear from one side that they perceive a concerted effort, in effect, to really put a squeeze on.

You gentlemen say, as I read the newspaper reports certainly of this meeting and other comments that you make, that that is not the case. In fact, the Comptroller, in a communication actually from the Board of Trade in this region, denied that there had been any change in policy, as I understand it.

Now, the people making the complaints are not unreasonable people. I mean, they are fairly able, bright people.

And, I really want out of this panel this morning some explanation for this gap that exists. If, in fact, as the regulators state, there is not a change in policy, that there is no concerted effort underway of the sort that there is apprehension about, then that needs to be made clear and understood by people.

And, it seems to me that if, in fact, that can be done and if, in fact, it reflects the underlying policy, you can do a lot to clear up the problems that are perceived in this area.

The dangers, of course, are walking the line between supervising in a careful way so you don't have activities that ought not to take place but not sending a message that is so strong that it, in effect, deters proper activity which may contribute to an economic slowdown and, indeed, even an economic turndown, particularly in regional situations.

Even if you accept Chairman Greenspan's general view of the country-wide situation, there is no doubt that there are regional problems that have been evidenced or that are felt by responsible people. And, I'm very anxious that the panel address that particular problem this morning.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Sarbanes. Senator Mack?

OPENING STATEMENT OF SENATOR MACK

Senator MACK. Thank you, Mr. Chairman. Speaking about different perspectives, I guess I do kind of come from this a little bit different perspective, at least with respect to some of the comments that have been made this morning. And, I don't want to overreact or be too harsh.

But, I guess—I wrote some comments down as I was listening to an earlier presentation in this sense: Free markets react to changes in the market. When you pass laws that effect markets, financial markets will react and judge the new risk, if any.

And, I would suggest that the following have had an impact on the amount of risk business must deal with and, as a result, banks and other financial institutions are going to take those new risks into consideration.

When you pass legislation that impacts that free market or proposed legislation that impacts that free market, again that risk is going to be reevaluated. You can't go through a series of market manipulations as a result of, say, plant closing legislation, minimum wage, mandatory benefits, parental leaves, environmental laws, building regulations and growth management laws without someone responding to those laws.

Now, I found myself coming into this meeting probably driven by many of the same kinds of stories that I know that all of us have heard. All over my State for the last several months as I traveled around and talked with people, I heard story after story after story about this "credit crunch."

I've always thought of a credit crunch in the sense of money supply being too tight and the liquidity in the banks being short and, therefore, lending being in a strain.

But, after listening to the various stories that were told to me, I then spoke to various banking organizations around the State to get their perspective of what was going on. And, what I heard was No. 1, that there really is not a shortage of money, and, No. 2, that, in fact, they were looking for "good loans."

They indicated that, yes, there are certain kinds of loans that they made in the past that they are not making today but did not put that in the context of saying that it's being done because the regulators are requiring them to do this.

In Florida, we have a very—I will say it's unique; other States may be dealing with it. We have a very fast growth State. I look at two areas where really right around my home, Naples, FL, for example, between 1980 and 1988 grew at the rate of 61 percent. Ft. Myers' population during that same period of time grew by 50 percent.

The State has reacted by passing legislation, growth management legislation, which requires putting into place the infra-structure before building permits can be granted. Now, if you are a financial institution, you are sure going to try to evaluate what the risk is as a result of that growth management plan.

Nobody has any idea how it's going to impact, growth and the availability of funds to put in this infrastructure.

So, as I say, I came to this hearing with I'm sure many of the same kinds of feelings that my colleagues have in the sense of hearing stories around the State of Florida about the tightening down of credit, of bank examiners coming in and sending a chill through a financial institution. And, again I've got to relate to you that having spent 16 years in the banking business, I know that when a bank examiner comes in and starts to write down loans that I thought were good quality loans—and would still argue today that many of those were good quality loans—it does send a wave throughout the financial institution.

I mean, the last thing that a commercial lender wants to do is go before the Board of Directors with a loan similar to the one that just got classified. And, so there is an impact.

And, I know of individuals in my State that, in fact, have been carrying unsecured lines of credit, substantial lines of credit, for years that are for the first time being asked to secure those lines of credit. And, I have, in fact, heard stories to the effect that properly performing loans have been written off, which suggests to me, you know, that there is something to this issue that we are talking about.

But, I felt that it was important to put a little balance into the equation in trying to say to my colleagues in the Congress that we need to take into consideration that legislation that we pass does, in fact, increase the risk of business in America. And, then to turn around and say that the banking community and the regulators shouldn't allow the financial institutions to take that risk into consideration is very, very dangerous.

So, I really look forward to your testimony this morning and just wanted to share those few thoughts with you.

The CHAIRMAN. Very good. Thank you, Senator Mack. Senator Kerry?

OPENING STATEMENT OF SENATOR KERRY

Senator KERRY. Thank you very much, Mr. Chairman. I really want to thank you also for your very, very quick response to our request to have this hearing. I am very appreciative of it.

As you can tell from the testimony of Congressman Kennedy and from comments that we have had in conversations, this is a matter of obvious urgency.

And, I join my colleagues in expressing gratitude to this panel for coming here and sharing thoughts with us today. I think it's a very important area to explore.

And, I think the more we can try to distinguish between fact and fiction and the reality of these policies the better served our community will be in trying to deal with the question of where do we go from here.

In the Northeast, in Massachusetts particularly, we are hurting in ways that I haven't seen since the early 1970's when we had 15 percent unemployment in some of our communities and people had doubts about the future. Now, I know that our growth in real personal income is not that far below the national average.

But, it has been continually going down. And, that trend, compared to where it was, is what is disturbing. And, I measure that against this 55 mile an hour, 65 mile an hour, analogy.

Employment in our region has dropped by over 70,000 jobs only 1 year ago. Two-thirds of those jobs in the region have been lost in Massachusetts. In the construction industry, we have lost 30,000 jobs during the last 2 years.

Now, regardless of the reasons for the current state of affairs, it is our sense that the current approach, whether justified or not at the outset, is creating a spiraling perception process that is having an enormous negative impact and an unnecessary impact on a lot of our businesses.

Our economic policy is obviously supposed to generate new jobs, supposed to generate growth, hold down inflation, et cetera. It is holding down inflation, but it is not doing any of the other things that it is supposed to do in our region.

And, I have become convinced that it is because of the high interest rates. It is because of some overzealous regulation. And, it's because of the psychology of an encroaching recession in our area that comes partly from a cyclical slowdown. But, also I am now convinced from the created downward spiral that comes from the process that has been put in place in reaction to the S&L crisis, the regulatory process.

This panel is as learned and as experienced as any that we could have to try to sort this out. And, I look forward to doing that.

And, I acknowledge up front—and I did so with Mr. Clarke at another meeting that we had with businesses from the New England region—that obviously part of our economic downturn is cyclical. We acknowledge that.

We also acknowledge that there were some outrageous loans being made even, you know, from some of our principal banks without collateral, without appraisals in some cases, and that money was being pushed out the door and that you needed regulation. We acknowledge all of that.

But, as I talked to businessmen in Massachusetts—and I've been talking to a lot of them, not just real estate people—on every side of the issue, small and large, new industries, venture industries and so forth, I can tell you without exception there is a belief that this spiral is partly Washington-created, regulatory-created.

And, I think we need to explore some of the specifics of that today.

The savings and loan crisis has created a very cruel irony for us in the Northeast, Mr. Chairman, because we are paying for the mistakes of other people twice, not just once. There has been a lot of discussion about who is to blame, and I don't want to go into the who for blame because there is blame to go around.

Congress made some mistakes, and the administration in its deregulatory process, and the regulators obviously made enormous mistakes.

But, we, in the Northeast, are paying for the failures of that process. While we shoulder approximately 47 percent of the nation's tax burden, only 10 percent of the bailout costs during the last 3 years are attributable to insolvent institutions in New England.

Texas pays only 7 percent of the Nation's taxes, but it's responsible for nearly 60 percent of the bailout costs. So, the first costs that our businesses are paying that they are really angry about, our taxpayers, is the fact that there is a significant subsidy going to our friends in Texas.

The second cost is less direct but it is equally hurtful. And, that's the psychology.

Because the regulators have been accused of being responsible for being asleep at the switch and not watching what happened, there is an obvious human reaction that says we are not going to let it happen again. And, in that reaction, as we have seen in the testimony of Bill Seidman previously, as I think we heard earlier today, they are going to err on the side of caution. That is an admitted policy.

Erring on the side of caution becomes an excuse for being too tough, for being unrealistic and for being able to avoid the real creditworthiness of an individual or a business, what their other assets may be and so forth. And, there are instances where loans have been termed "nonperforming" in this context.

I know the testimony today will address this. And, that has upset the balance of reasonableness.

And, I will tell you, that anger is expressed in very basic ways. I've got businessmen who come to me and say, "What the hell is going on in New York? How could you guys have let Donald Trump get these kinds of loans? How could you have done that? And, here I am, a businessman in Massachusetts running a small shop, paying consistently, and I'm now having my loan called even though I'm totally creditworthy, and if you look at all the rest of my assets I'm good for this."

Now, that is something that every citizen understands. They also understand how we have rolled over loans for Third World countries, refinanced them, and how we bend over backward in order to let people who are struggling to repay have a second chance or make it work.

Now, I heard Senator Garn's comments, and I'm sympathetic. But, there has got to be some reasonableness in this process, some reality. And, I think that is what our business people are screaming for.

We have got a psychology that has now set in where businesses in their right mind aren't going to decide to move there. So, we've got to address this today.

And, I've got a number of questions that are going to try to probe it a bit with the hopes that we can do it.

And, the final thing I want to say is, the S&L borrowing process is also driving. You look at that inequity and the balance of our responsibility for it, and then you look at the question of how much of the S&L crises is now tightening credit itself because of the borrowing the Treasury has to do, which drives up interest rates.

And, I harken you to the comments of Felix Wharton who suggested that it's an enormous mistake for us that the bailout is basically flawed, because the borrowing of billions of dollars to reimburse depositors, he suggests, "will turn a $130 billion problem into a $500 billion drain over the next 20 to 30 years, leaving our children to pay off our own stupidity."

And, I think we ought to take a hard look at that issue. And, I hope we will do that today.

Mr. Chairman, I went longer than I should have, I know, but I wanted to express that concern.

The CHAIRMAN. Well, very good, Senator Kerry. Senator Heinz, this hearing today is being held in response to the letter that you and others sent.

So, let me invite you to make any opening comment you wish to make.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Mr. Chairman, I will be very brief. And, I do thank you for responding to the letter that the four of us, Senator Dodd, Senator Kerry, Senator D'Amato and I, sent you. I guess it was early last month.

And, I think this is a terribly important hearing. It's important not only because many of us are trying to understand why we are being barraged with letters and calls from our constituents, many of them in real estate development, but why we get differing stories from many of our financial institutions.

I have had financial institutions, who have requested to remain unnamed, say, "Well, we are being subjected to a double standard. People are being much tougher today than they were before." In some cases, they say that the new standards are unreasonable but then do not want to go to the regulators because—or to Mr. Clarke, who has had an open door, I think because they say they are afraid of retaliation.

Most of that is to be expected when there is a change in the way the standards are enforced. And, although I, myself, have met with the Comptroller in an effort—we spent about an 1½ or 2 hours together—to try and understand what was going on, and he has offered to have any number of meetings, open meetings appropriately, with either effected people seeking credit or people who are lenders.

I think this hearing gives us a chance to answer a couple of critical questions. Perhaps the most critical one is the assertion that the regulators, the bank examiners, are now doing what they should have been doing all along.

They are now enforcing the rules the way the rules were meant to be enforced. If that's true—and there is a lot of evidence that the standards of underwriting that are now being applied, while in the rule book are no different, are now being applied more stringently—the first question that comes to mind is: Who is responsible for the failure to have applied them more stringently over the last 2, 4, 6, 8, 10 years?

If the examiners haven't been enforcing the law or the regulation or the standards of underwriting the way they should have been, why aren't any of them being disciplined? Why aren't any of them being fired?

We have had a regulatory regime, the Fed, the Comptroller, the FDIC, FSLIC formerly—no longer there, now Office of Thrift Supervision—as a single regulator, one person in this vast regulatory bureaucracy that, after all, is supposed to do its job and by imposing a standard of creditworthiness on the lenders and the loans that they write. Has anybody ever been taken to task?

If there have been people taken to task, it would be news to this Senator. It doesn't mean it hasn't happened.

But, it seems to me that if there hasn't been an effort to find out on the part of any of our regulators whether or not the regulatory system itself was flawed because people made errors or there were other problems, we would certainly like to hear about it.

The second point is that I worry that there not only was but there still is a double standard in the way our regulators are approaching credit.

For example, there is no doubt that the Fed turned a very benign eye on LDC lending over most of the last 15 years. The Fed said, "Oh, we can't get tough with those big New York banks on those big loans to less developed countries," and came up with a tremendous bunch of rationalizations about how, "Oh, you can always depend on sovereign countries to repay their debts."

Well, fortunately, I haven't heard that in the last 4 or 5 years. But, even to this day, I believe that there is a double standard on treating credit decisions on real estate, for example, differently from credit decisions and decisions to extend more money to developing countries to pay their interests to us.

And, probably—although I haven't examined it in detail—there is still a different and hard to justify standard on the way high yield instruments, so-called junk bonds, are being treated.

So, if it's good to be this tough on real estate, I would like to hear why it isn't good to be just as tough—and I know many people say, "We are being just as tough," and I hope you do, because I have some very good questions for you if you do say that.

And, finally, Mr. Chairman—I've gone on too long—there is one thing we have heard a lot about over the last 3 or 4 months in this committee, and it is the size, the growing size, the scandalously growing size, and cost of the savings and loan rescue, bailout scandal.

But, while we have been presented with a larger and larger bill, the one thing that we haven't seen is efforts by our regulatory and law enforcement system to take the people who obviously defrauded the Government, did things that were illegal and turn them upside down and shake them until every last penny that they stole, expropriated, or were guilty of misapplying, falls out of their pockets. I haven't seen anybody being called to make personal restitution.

And, I haven't seen anybody yet be put in jail, let alone indicted. And, we've had this problem for 3 or 4 years.

And, that's why this Senator is going to be offering on the crime bill a package of amendments that is going to require that our regulators and the Department of Justice and others get serious, get tough and get action when it comes to going after the people who perpetrated the fraud on the taxpayer that the savings and loan bailout represents.

Mr. Chairman, I thank you and I apologize to my colleagues for taking that much time. There were a number of things that I felt that this group needed to hear.

And, I apologize to my colleagues. I know many of them feel the same way.

The CHAIRMAN. I think it is important that our witnesses today get some sense of the strength of feeling that the Senators have.

Senator Shelby?

OPENING STATEMENT OF SENATOR SHELBY

Senator SHELBY. Mr. Chairman, I will try to be brief, because I did come here to listen to the witnesses. But, I would be remiss if I didn't comment on what the Senator from Florida, Senator Mack, and the Senator from Massachusetts, Mr. Kerry, said.

I think they both, in their respective ways, articulated the problem and the perception. I believe there is a problem, because I don't believe you would be here today and I don't believe Senator Mack and Senator Kerry would have articulated their respective problems in different parts of the country.

I have those problems in the south, in Alabama. So, I think what I believe, and I've believed a long time, you do have a job as regulators. You have a tough job.

And, perhaps we have been too lax, or you have, in the past. But, I believe you have a responsibility in the banking system to provide credit for worthy people who have had a history of paying and not just squeeze out the small businessman, as Senator Kerry alluded to, or squeeze out or call a loan that is performing and has always performed, as Senator Mack mentioned, a nonperforming loan.

Something is wrong with the regulators. Maybe they are afraid of you. But, I believe we have a greater responsibility, and I think you do.

Something that has bothered me and others around, has this credit crunch—and I believe it's out there, I believe it's more than a perception, has the rule on the loan to one borrower restriction, has that compounded it? I know it couldn't by itself, but there is a problem out there with the homebuilders or the real estate people, people who have never defrauded a savings and loan, people that are in business, people who have good balance sheets, but all at once have been cut off from their credit.

And, you can't build and sell, and you can't operate a small business in Massachusetts or Florida or Alabama or Maryland or wherever, if you don't have credit. And, people do look out there and they look at the Donald Trump's and they look at the Third World debt, and they say, "What about me? You know, I've paid my taxes. I've paid my bank." And, then you are squeezing them.

And, I think that is something you need to look at as regulators. Otherwise, we are going to be laying off thousands of people all over this country just like the Senator from Massachusetts is talking about is happening in his region.

And, I don't believe anyone at this table, here at this table or yours, would want that.

Thank you, Mr. Chairman.

The **CHAIRMAN**. Thank you, Senator Shelby. Senator Wirth?

OPENING STATEMENT OF SENATOR WIRTH

Senator **WIRTH**. Thank you, Mr. Chairman. I only want to echo the point that you made in your opening statement about the need for balance.

There is a certain amount of irony here that on the one hand Members of the Congress are saying to all of you, "Regulate much more dramatically," but on the other hand saying, "Hey, wait a minute. It may be that the economy is slowing down and we've got to ease up on credit, so don't regulate so much."

I mean, that has not gone unnoticed, at least by this Senator. And, I think that the chairman struck a balance very, very well in his opening statement about just precisely that.

And, I look forward to hearing from you. Thank you very much for being here and maybe most importantly for undertaking this enormously difficult and probably thankless task of trying to be the balancers.

Thank you, Mr. Chairman.

Senator **SARBANES**. Mr. Chairman——

The **CHAIRMAN**. Yes, Senator Sarbanes.

Senator **Sarbanes**. Mr. Chairman, I may have to go to another meeting, but I just wanted to reemphasize a point I made at the outset.

I am very deeply concerned about the difference in perceptions that exist. Mr. Clarke, you say here in your statement that you believe that the responses are based on an inaccurate view of your supervision.

And, somehow, you know, you are not talking about irrational people out in the private sector. These are very rational people, and they have a certain perception of what is happening.

You all say that's not what is happening. So, you have a different perception.

I am reminded of when I worked for Walter Heller when he was the Chairman of the Council of Economic Advisors and he would be explaining something and someone would say, "Well, I'm sorry, I didn't understand the explanation." And, Heller would then say, "No, I'm sorry. I didn't make a good explanation."

And, that's something of the problem that I think may be involved here and something I hope you can clarify here today at the witness table.

The **Chairman**. We will make your full statements a part of the record. Chairman Greenspan, we are pleased to have you lead off.

Please, pull that mike up a little closer, so that those at the back of the room can hear you.

STATEMENT OF ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM, WASHINGTON, DC

Mr. **Greenspan**. Thank you very much, Mr. Chairman. I certainly welcome this opportunity to discuss the issue of credit availability—whether it has changed and, if so, why—and its effects on the health of the economy.

We at the Federal Reserve have for some time been monitoring various indicators of credit supply and have been assessing implications for the economic expansion. To date, we have found that lenders have tightened their standards in certain sectors and locales, but that there has not, so far at least, been a broad-based squeeze on credit, and lenders are generally not retreating from lending opportunities. Nonetheless, significant problems cannot be ruled out in the period ahead, and we will continue to devote close attention to credit conditions.

Let me preface my remarks today by emphasizing the necessity of a stable, efficient financial system, including sound depository institutions, for satisfactory economic performance. Vigilant, consistent supervision, strong capital positions, as well as actions by lenders to avoid excessive exposure when new risks appear, are all essential to retaining public trust in our depository system.

The efforts of our examiners reflect this dictum. Our standards in these areas have not been tightened, though they may, because of deteriorating conditions in certain markets, be catching more doubtful loans than before. This process may cause difficult, short-run adjustments in those markets, but these must be viewed as reactions to changing circumstances and a correction of earlier overenthusiasm on the part of lenders. Ultimately this should prove to be a positive force for the economy by preserving the health of our commercial banking system.

Of course, anecdotal reports suggest that some bankers and their regulators have become overly cautious and have thereby exacerbated the very problems they have been trying to avoid. It is difficult to get hard evidence to assess the extent of this problem, but I suspect that, since many loan extensions of recent years are now nonperforming, it is inconceivable that bankers and their regulators would not currently have turned cautious, either consciously or subconsciously. To believe otherwise presumes a change in human nature.

Although some increased caution unquestionably is prudent in current circumstances, the issue is whether, owing to an overreaction on the part of some lenders or regulators, creditworthy borrowers are being denied funds. Potentially, such unwarranted caution can put downward pressures on asset values, stunt investment or spending more generally, and thereby curtail employment.

To date, however, whatever overreaction that may have occurred does not appear to have been widespread, and access to credit has not been reduced to an extent that has had a significant dampening influence on the American economy overall. Some sectors of the economy, however, are stronger than others, and particular weakness is apparent in some real estate markets. The most substantial adjustments have been underway for some time in the commercial real estate and construction industry.

The cause of this weakness almost surely rests in the excesses of earlier years. Developers and their equity partners built housing and commercial structures at a more rapid pace than could be supported by economic fundamentals. The overbuilding was financed in part by the ready availability of credit from thrifts and banks that, in hindsight, partly reflected lax lending standards and, unfortunately, insufficient attention by supervisors.

Paralleling the softness in activity, lending by depository institutions for real estate purposes has slowed this year. Both banks and thrifts appear to be reacting to the worsened prospects for real estate projects and, particularly for thrifts, a more stringent regulatory environment.

In contrast to the situation with commercial real estate, credit market conditions appear more resilient in the market for residential property. The continued flow of credit in residential mortgage markets probably owes to the many alternatives to depository credit. The securitization of home mortgages has become a routine financial transaction. Buyers of these securities, such as pension funds, insurance companies and mutual funds have stepped up to acquire assets shed by thrifts and to fund new lending.

Outside of the real estate sector, one area where banks unquestionably have made credit less available is the financing of corporate mergers and restructuring. The pullback from lending to highly leveraged borrowers has contributed to recent sluggish growth in commercial lending, though it is not the only factor. In last month's Federal Reserve survey, senior lending officers reported weakness in nonmerger-related commercial lending as well.

Greater caution with regard to commercial lending probably is warranted in the current economic environment. The decade of the

1980's was a period of rapid leveraging of many corporations and the resulting debt burdens probably made some deterioration of credit quality all but inevitable.

Nonetheless, with the exception, perhaps, of the troublesome situation in the New England region, credit availability more broadly appears not to be significantly impaired. Moreover, it is worth noting that while banks are principal suppliers of credit to certain classes of borrowers, they supply less than a quarter of total net borrowing in the broader economy. Other credit conduits generally show little or no stress. For example, the volume of issuance in most securities markets, smoothing through the volatility, generally has been well maintained. In addition, spreads of interest rates on private over government issues in these markets have remained quite narrow. If reluctance by banks and thrifts to make loans were inhibiting the overall flow of credit in the economy, it should be visible in conditions in the credit markets, including higher yield spreads.

The pace of aggregate credit flows upholds this impression. Credit growth has eased, but debt still appears to be growing about as fast as GNP, a relationship typical of the three decades before the 1980's.

Of course, the link between current debt growth and economic activity is a loose one. Indeed, it is plausible to expect that impaired credit availability would have lagged effects on debt and spending, as first commitments are cut back, then actual lending, and finally consumption and investment. Naturally we are alert to this possibility and are complementing our attention to debt and credit flows with close scrutiny of a full panoply of related indicators.

All things considered, continued modest economic growth remains the most likely outcome and enough credit appears to be available to fuel this growth. Certain sectors or individual borrowers appear to be having trouble obtaining credit, but these specific difficulties are largely consistent with lenders' and regulators' reactions to shifting risks.

We are attentive to the possibility that this more cautious stance in the granting of credit could cumulate to threaten the economic expansion and are closely monitoring the evolving complex interrelationships between credit availability and economic expansion.

Thank you very much, Mr. Chairman.

[The complete prepared statement of Alan Greenspan follows:]

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Testimony by

Alan Greenspan

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing & Urban Affairs

United States Senate

June 21, 1990

Mr. Chairman and members of the Banking Committee, I welcome this opportunity to discuss the issue of credit availability--whether it has changed and, if so, why--and its effects on the health of the economy. We at the Federal Reserve have for some time been monitoring various indicators of credit supply, and have been assessing implications for the economic expansion. To date, we have found that lenders have tightened their standards in certain sectors and locales, but that there has not, so far at least, been a broad-based squeeze on credit, and lenders are generally not retreating from lending opportunities. Nonetheless, significant problems cannot be ruled out in the period ahead, and we will continue to devote close attention to credit conditions.

The topic of credit availability is intertwined with the issue of the asset quality of depository institutions. Let me preface my remarks today by emphasizing the necessity of a stable, efficient financial system, including sound depository institutions, for satisfactory economic performance. Healthy commercial banks and thrift institutions promote growth by providing a ready source of loans, especially to households and smaller businesses that lack direct access to credit markets. By exercising sound credit judgments, deposit intermediaries direct funds to productive uses and by offering secure, liquid deposits to the public, they encourage thrift.

Doubts about the soundness of depositories can disturb this process. When depositors and investors become reluctant to entrust their funds to these institutions, access to depository credit can be curtailed or become more expensive. Vigilant, consistent supervision, strong capital positions, as well as actions by lenders to avoid excessive exposure when new risks appear, are all essential to retaining public trust in our depository system.

The efforts of our examiners reflect this dictum. When examiners visit a bank, they determine whether it has adequate systems in place to measure and control its risk exposure. In addition, they ascertain whether borrowers have sufficient collateral and cash flow, given local market conditions, to service their loans. Our standards in these areas have not been tightened, though they may, because of deteriorating conditions in certain markets, be catching more doubtful loans than before. This process may cause difficult, short-run adjustments in those markets, but these must be viewed as reactions to changing circumstances and a correction of earlier overenthusiasm on the part of lenders. Ultimately this should prove to be a positive force for the economy by preserving the health of our commercial banking system.

Of course, anecdotal reports suggest that some bankers and their regulators have become overly cautious, and have thereby exacerbated the very problems they have been trying to avoid. It is difficult to get hard evidence to assess the extent of this problem, but I suspect that, since many loan extensions of recent years are now nonperforming, it is inconceivable that bankers and their regulators would not currently have turned cautious, either consciously or subconsciously. To believe otherwise presumes a change in human nature.

Although some increased caution unquestionably is prudent in current circumstances, the issue is whether, owing to an overreaction on the part of some lenders or regulators, creditworthy borrowers are being denied funds. Potentially, such unwarranted caution can put downward pressures on asset values, stunt investment or spending more generally, and curtail employment.

To date, however, whatever overreaction that may have occurred does not appear to have been widespread, and access to credit has not been reduced to an extent that has had a significant damping influence on the American economy overall. On balance, the economy appears to be growing at a subdued pace so far this year, in line with the recent slower growth of our labor force, thus keeping the unemployment rate around 5-1/4 percent. In several sectors conditions have been difficult to read owing to distortions such as last winter's unusual weather. But, available indicators suggest that overall activity remains on a slow uptrend.

Indeed, moderate growth is inevitable at this stage of the expansion given that we no longer have considerable slack in resources to be taken up. Late last year, indications that a slowdown was in train led to concerns that the weakness would cumulate to a recession. Now those concerns seem to have less basis. One reason is that producers and distributors apparently trimmed their inventories rather promptly this winter, most notably in the auto industry but elsewhere as well. With this period of adjustment complete, factory output in recent months has picked up a bit, and at this stage, inventories appear to present no impediment to further growth in production.

Some sectors of the economy, however, are stronger than others, and pertinent to the topic of these hearings, particular weakness is apparent in some real estate markets. In the residential market, unusually favorable weather early this year temporarily boosted housing starts, but more recent monthly numbers appear to reveal some underlying softness in this market. The most substantial adjustments have been underway for some time in the commercial real estate and construction industry. Construction of office buildings and other commercial structures is down from last year's pace. There are, of course, regional differences to the real estate slowdown. Nonetheless, in the aggregate, the statistics clearly indicate considerable softness. And forward-looking measures, such as contract awards and building permits, suggest this weakness is likely to continue a while.

The cause of this weakness almost surely rests in the excesses of earlier years. Developers and their equity partners built housing and commercial structures at a more rapid pace than could be supported by economic fundamentals. The overbuilding was supported in part by the ready availability of credit from thrifts and banks that, in hindsight, partly reflected lax lending standards and, unfortunately, insufficient attention by supervisors. Speculation, fed by visions of ever-rising prices, also led to new construction that simply outpaced demand in many markets. When properties were completed, there were not enough buyers willing to pay prices that covered construction costs or tenants willing to pay enough rent to cover mortgage payments and operating costs. The most obvious signs of this overshoot are the high vacancy rates for office buildings, rental apartments and condominiums. For example, the average office vacancy rate for downtown areas increased from near 5 percent at the start of the 1980s to over 16 percent by the end of the decade, and has reached 25 to 30 percent in some parts of New England and the Southwest. Residential markets also have been affected, though less severely, with prices levelling off and even falling in some markets, and sales of new homes at their lowest rate since 1982.

Paralleling the softness in activity, lending by depository institutions for real estate purposes has slowed this year. In large measure, this reflects the absolute contraction of the assets of thrift institutions which, historically, specialized in this market. And, while banks' real estate lending has slowed only slightly, they have been unwilling to fill all of the void left by thrifts. Both banks and thrifts appear to be reacting to the worsened prospects for real estate projects and, particularly for thrifts, a more stringent regulatory environment.

In the case of S&Ls, provisions of the FIRREA legislation limited the amount a thrift institution could lend to one borrower. This reportedly had a marked effect on construction financing in many markets, and some developers have been forced to find new sources of credit. Commercial banks also have pulled back from commercial real estate lending. Data for all commercial banks show a small contraction in credit for construction and land development in the first quarter of 1990, and a reduced rate of expansion in mortgages on existing commercial properties. In the several surveys of senior bank lending officers we have conducted this year, a large majority consistently have indicated that they were very reluctant to extend credit in these areas.

A falloff in credit demand and deteriorating conditions in the real estate sector appear to lie behind much of banks' reduced lending. In one survey taken last January, almost all banks that had pulled back from construction lending did so because of a less-favorable economic outlook. In addition, half of them cited problems with such credits in their own portfolios as a factor. These concerns are substantiated in an increased delinquency rate for real estate loans which, in the first quarter, reached its highest level since 1984. Only a minority of bankers have reported to us that increased regulatory pressure or tighter capital requirements caused them to curb their supply of credit.

In contrast to the situation with commercial real estate, credit market conditions appear more resilient in the market for residential property. This was the main market of the savings and loan industry, and residential mortgage credit has accounted for the bulk of their asset reductions. Nevertheless, there are no indications that permanent financing for purchase of an existing home has become more difficult to obtain. Interest rates charged on home loans have not risen on balance relative to other long-term rates, and lenders generally have not tightened downpayment requirements. A recent trade association survey of mortgage bankers concluded that ample funds were available for home buying, and, indeed, the volume of existing home sales, which is sensitive to credit availability, so far this year has held close to the pace of last year.

The continued flow of credit in residential mortgage markets probably owes to the many alternatives to depository credit. The securitization of home mortgages has become a routine financial transaction, with about $1 trillion in mortgage debt held in that form. Buyers of these securities, such as pension funds, insurance companies, and mutual funds, have stepped up to acquire assets shed by thrifts and to fund new lending. Commercial banks have been avid purchasers as well, even while they have slowed the pace of their direct residential mortgage lending.

Outside of the real estate sector, one area where banks unquestionably have made credit less available is the financing of corporate mergers and restructuring. Banking regulators have specifically instructed banks to review their procedures in this area, and a majority of bank lending officers surveyed in January reported that they had tightened their standards for loans to highly leveraged borrowers. This is one sector where the decisions of banks can be corroborated by financial markets more generally. As you well know, the market for junk bonds slumped badly earlier this year, and new issuance has slowed to a trickle.

A pullback from lending to highly leveraged borrowers has contributed to recent sluggish growth in commercial lending, though it is not the only factor. In last month's survey, senior lending officers reported weakness in commercial lending to all sizes of borrowers. In the case of larger borrowers, reduced demands for credit were cited by survey respondents as the primary reasons for the slower pace of lending, while more stringent credit standards and tighter loan terms were quoted more frequently than reduced demand for smaller borrowers. Recent surveys of small businesses do reveal some near-term reduction in credit availability. However, small businesses consistently report difficulties in obtaining loans, and credit conditions have not become appreciably tighter relative to a year ago.

Greater caution with regard to commercial lending probably is warranted in the current economic environment. The decade of the 1980s was a period of rapid leveraging of many corporations, and the resulting debt burdens probably made some deterioration of credit quality all but inevitable. Indeed, banks are reporting increased delinquency rates on commercial lending.

Nonetheless, with the exception, perhaps, of the troublesome situation in the New England region, credit availability more broadly appears not to be significantly impaired. Banks reportedly remain ready to make loans to larger and more creditworthy commercial borrowers, and they consistently have reported increases in their willingness to extend credit to consumers. Moreover, it is worth noting that while banks are principal suppliers of credit to certain classes of borrowers, they supply less than a quarter of total net borrowing in the broader economy. Other credit conduits generally show little or no stress. For example, the volume of issuance in most securities markets, smoothing through the volatility, generally has been well maintained. In addition, spreads of interest rates on private over government issues in these markets have remained quite narrow. If reluctance by banks and thrifts to make loans were inhibiting the overall flow of credit in the economy, it should be visible in conditions in credit markets, including higher yield spreads.

The pace of aggregate credit flows upholds this impression. Credit growth has eased, but debt still appears to be growing about as fast as GNP, a relationship typical of the three decades before the 1980s. In part, at least, the economy may be seeing the cessation of the unusually heavy borrowing pace of the 1980s, certainly a salutary development to the extent it promises lower leverage and healthier balance sheets.

Of course, the link between current debt growth and economic activity is a loose one. Indeed, it is plausible to expect that impaired credit availability would have lagged effects on debt and spending, as first commitments are cut back, then actual lending, and finally consumption and investment. Naturally we are alert to this possibility and are complementing our attention to debt and credit flows with close scrutiny of a full panoply of related indicators.

The monetary aggregates are among such indicators, containing as they often do portents of future spending trends. Both M2 and M3 have slowed to relatively low growth rates this year, more so than we had anticipated last February. The massive redirection of credit flows that has accompanied the government's program to close insolvent savings and loan institutions appears to have depressed growth of M2 as well as M3, somewhat degrading the value of both aggregates as indicators. On net, commercial banks are taking up relatively little of the lending foregone by the shrinking thrift industry; the resultant cutback in total lending by depository institutions has slashed their needs for funds, showing through directly to M3. Even at the M2 level, the reduced need for funds by both commercial banks and thrifts appears great enough to have reduced the aggressiveness with which these institutions have pursued deposits. Terms offered on deposits have become less generous, and depositors have been turning to alternative financial assets. At least some of the recent weakness of M2 has come from this channel. However, there is still some unexplained weakness in M2 and M3 which will require continuing scrutiny.

Summary

All things considered, continued modest economic growth remains the most likely outcome, and looking at the economy as a whole, enough credit appears to be available to fuel this growth. Certain sectors or individual borrowers appear to be having trouble obtaining credit, but these specific difficulties are largely consistent with lenders' and regulators' reactions to shifting risks. We are attentive to the possibility that this more cautious stance in the granting of credit could cumulate to threaten the economic expansion and are closely monitoring the evolving complex interrelationships between credit availability and economic expansion.

The CHAIRMAN. Chairman Greenspan, thank you very much. I know there will be questions for you.

Before we go to the next witness, I want to raise one other item with you very briefly. Their is an article in the New York Times this morning, which I'm sure you have seen, entitled "Fraud Uncovered in Property Sales in Savings Rescue, Wider Abuse is Expected."

The article covers the disposition of assets taken back from failed S&L's. As you serve on the RTC Oversight Board.

I want to ask you whether or not you feel that there is a problem with respect to fraud. Is it your sense that we have a problem there?

Mr. GREENSPAN. Well, unfortunately, Mr. Chairman, I have not as yet had a chance to read that article. I am familiar with its existence.

I would prefer actually to read the article and get its substance before I respond to you. And, I shall be glad to do so in writing.

The CHAIRMAN. Well, let me make this suggestion. In the reform legislation we established an inspector general. Jack Adair is now confirmed and in that job. It is his responsibility to monitor this kind of problem.

I would like you to convey my concern and the committee's concern about this story. I would like you to sit down with Mr. Adair and size this up. Within a week I would like to have the Board's assessment.

Mr. GREENSPAN. This is the Oversight Board you wish me to do this with?

The CHAIRMAN. Yes. I would like the Oversight Board to assess whether or not there is a problem here and what is being done to deal with it.

The inspector general would be in a position to assist. Can we have an understanding that within a week's time we will receive a response on this issue?

Mr. GREENSPAN. Yes, sir.

[The following information was subsequently submitted for the record:]

OVERSIGHT BOARD
RESOLUTION TRUST CORPORATION
Washington, D.C. 20232

August 7, 1990

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

This is in response to your letter of June 28, 1990 to Chairman Greenspan, and to the oral request you made of him before your Committee on June 21, that the Oversight Board, in consultation with the Inspector General of the Resolution Trust Corporation, assess the charges made in a front page article of the New York Times, dated June 21, 1990, titled "Fraud Uncovered in Property Sales in Savings Rescue."

The RTC has referred to the Department of Justice a small number of cases in which it has appeared that an application for the purchase of property included false information. On a larger scale, the RTC has established procedures and is developing systems to screen individuals and firms seeking to provide asset management services for the RTC.

The Times article has been discussed with the Inspector General, who has prepared a memorandum on this matter, which I am enclosing.

Notwithstanding its title and statements made in its opening paragraphs, most of the article, including the quotations from various sources, concerns the possibility of future fraud or misconduct. The Oversight Board is fully aware that fraud, waste, or misconduct could increase substantially the costs of the RTC's disposition of assets of failed savings associations, and it intends to guard against possible or potential fraud, waste, and misconduct very carefully in carrying out its statutory duty to review the performance of the RTC on a periodic basis.

With respect to specific matters mentioned in the article, the Inspector General, as indicated in the enclosed memorandum, will consider each of them as his Office develops and implements its audit plan. The Oversight Board as well as the RTC will consider carefully the results of that work.

Some of the material in the article, such as the implication that buyers of property should be screened as carefully as purchasers of savings and loans, are issues that the Oversight Board and the RTC will be addressing in an ongoing process of policy formulation and re-evaluation based upon the RTC's statutory goals.

I hope that this is responsive to your request.

Sincerely,

Pete Monroe

Peter H. Monroe
President
Oversight Board

Enclosure

RTC
Resolution Trust Corporation

DATE: June 29, 1990

MEMORANDUM TO: Peter Monroe, President, RTC Oversight Board

John J. Adair

FROM: John J. Adair, Inspector General, RTC

SUBJECT: Senator Riegle's Request Regarding June 21, 1990 New York Times Article on Fraud at RTC

In response to the subject request, we are providing the following observations. In general, we agree that the potential for fraud involving RTC and its operations is great. We intend to work with RTC to ensure it has sufficient controls to prevent and detect fraud, waste, and abuse. To begin accomplishing our objectives, we expect to have 15 to 20 staff on board next month. Additional comments on specific portions of the article are provided below.

Potential for Fraud - As your are aware, RTC will have to sell or otherwise dispose of hundreds of billion of dollars of assets. An undertaking of this magnitude has no precedent. Therefore, even if we only consider the tremendous amount of money involved, we would have to agree with the article's overall assertion that the potential for extensive fraud and abuse clearly exists at RTC. Compounding this situation is the fact that FIRREA mandates that RTC use the private sector to the extent practicable and efficient in carrying out its operations. As evidenced by the HUD and Defense contracting scandals, using the private sector entails a significant amount of risk. It is our job to help RTC minimize that risk.

Under the Inspector General Act of 1978, as amended, the RTC Office of Inspector General is to conduct audits, investigations, and related activities directed toward preventing, detecting, and prosecuting fraudulent acts and eliminating abusive practices in RTC programs and operations. With this mandate, my office intends to work with RTC to ensure it has sufficient controls and safeguards to prevent and detect fraud, waste, and abuse. We are currently developing our audit plan which will outline the work

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we intend to do to ensure that RTC's controls to prevent and detect fraud and abuse are working. Our plans will include work to review areas with a high degree of risk of fraud or abuse. You can be assured that audits designed to review and comment on RTC's controls over the selection and monitoring of contractors are high on our list of priorities.

Staffing of the Office of Inspector General - As the article pointed out, I began my tenure with RTC in early-April 1990, less than three months ago, and have appointed four staff to date. During this time, we have been developing our organizational structure and audit plans and interviewing numerous individuals for positions in the Office. I want to ensure that the people we do hire are of the highest caliber, and finding the best people takes time. We expect to have 15 to 20 auditors and investigators on board by the end of July. Although we would have liked to have had more staff on board by this time, starting an organization from scratch is difficult. We are continuing our efforts to increase our staff size and capabilities, while immediately putting new staff to good use reviewing RTC's operations and fulfilling specific Congressional and other requests for audits and investigations.

Specific Issues Raised by Article - The article raised specific questions/issues on (1) salaries and fees paid to consultants and former executives of failed institutions, (2) expenses billed to RTC by interim asset managers, (3) lack of oversight of billed expenses and general shortage of staff at RTC, and (4) background checks of winning bidders. The article also speculated that property developers and speculators who defaulted on loans could purchase property that served as collateral for those loans. Because we have not done any detailed work in those areas yet, we cannot specifically comment on them. However, we should note that in testimony before Representative Vento's task force, David Cooke discussed the issue of salaries and fees paid to consultants and executives.

The issues of expenses billed by contractors, oversight of contractors and staff shortages, and background checks of winning bidders were apparently raised by the General Accounting Office, who should be in a position to address any of Senator Riegle's concerns. We discussed those issues with GAO and were told that those were GAO's preliminary observations based on visiting 4 of 14 consolidated offices and reviewing remittances from 4 out of 52 interim asset management contracts. This work was done during April and early May 1990. GAO said that it has not issued a report on its observations and was only using them in planning detailed work to do at RTC. We are closely coordinating our audit efforts with GAO and will take these issues, actions RTC has taken in response to GAO's findings, and GAO's plans into consideration while developing our audit plan.

In regard to the issue of developers and others purchasing property that served as collateral on loans on which they defaulted, the article pointed out that such purchases are not illegal. Therefore, whether to allow such purchases appears to be a policy issue. We have not done any work which would allow us to comment on the issue.

cc: Mr. Seidman
Mr. Cooke

The **Chairman**. Very good. Mr. Fritts, it's not easy to stand in for Bill Seidman and on short notice.

But, you have an excellent reputation, and we are very pleased to have you. We would like to hear from you at this time.

STATEMENT OF PAUL G. FRITTS, DIRECTOR, DIVISION OF ENFORCEMENT, FEDERAL DEPOSIT INSURANCE CORPORATION, WASHINGTON, DC

Mr. **Fritts**. Thank you, Mr. Chairman and members of the committee. I appreciate the opportunity to address the committee on the topic of credit availability.

My remarks will focus on the so-called credit crunch debate. Specifically, I will address the condition of real estate markets and real estate lending by banks across the country. I also will review the supervisory policies and practices followed by the FDIC.

We define credit crunch as a general unavailability of credit to creditworthy borrowers for legitimate and viable purposes. This is in contrast with a credit contraction which is generally defined as a phase in the normal market real estate cycle.

What we see are mixed signals. There may be isolated instances across the country where creditworthy borrowers with viable projects to finance are being denied credit. This is no different than it has always been. However, we have not seen any evidence that such credit denials are anything more than isolated instances.

We are, however, seeing increasingly clear signs of a credit contraction. Moreover, we are seeing a downturn in certain types of real estate lending by banks. Our first quarter data for the commercial banking industry shows that the growth rate for construction and land development loans dropped to zero. That is, after a steady number of years of increases, total construction and land development loans remained constant for the first quarter.

However, other types of real estate lending continue to show normal growth. Chart No. 1, attached to my written statement, indicates that commercial real estate lending continues at a 12-percent annual growth rate. Home mortgage loans and mortgage backed securities grew at almost the same annualized rate in the first quarter.

In fact, real estate lending continues to account for an increased portion of overall bank lending. About 40 percent of all bank loans are now real estate-related. In addition, while total bank assets increased by only 5.1 percent from the first quarter of 1989 to the first quarter of 1990, real estate loans increased by 11.8 percent over that same period.

Greater dependence by banks on real estate lending comes at a time when real estate markets are weakening, not just in New England, but across many parts of the country.

Chart 2 indicates that as of the end of the year 1989, there were 20 States where banks had noncurrent real estate loans that exceeded 2 percent of total real estate loans. Only 3 months later, our first quarter data show 28 States, from 20 to 28, where a percentage of noncurrent real estate loans exceed 2 percent. More than half of these states have a noncurrent ratio of 3 percent or higher.

The CHAIRMAN. May I just interrupt you there for a moment. That would seem to be a rather rapid increase in a very short space of time. Is that typical or is that unusual?

Mr. FRITTS. I would suspect, although I don't have the figures right off the top of my head, that in the 1983–84 period in the Southwest, I would not doubt that those kind of figures would have been replicated.

The CHAIRMAN. You would have to go back that far to find another such extreme build-up of problems in that many States in that short a period of time?

Mr. FRITTS. I would suspect that is exactly right.

The CHAIRMAN. Do you conclude that this thing is still spreading and that another quarter, or another two quarters will continue to boost those numbers? Is this thing going to touch most of the country before it is over?

Mr. FRITTS. The Federal Reserve may be in a better position to comment on that than me, but I will say this: That we do expect some continuing slowness and softness in the real estate markets. We don't think it has bottomed out in New England yet. We see some softness beginning to develop in California, and we don't expect the problem to continue at this pace, but we do not see it going away in the near term.

The CHAIRMAN. I gather from what you said this is a growing problem and you expect some further enlargement with more States going on the list?

Mr. FRITTS. We do.

The CHAIRMAN. Why don't you continue? Thank you.

Mr. FRITTS. The first quarter figures on noncurrent real estate loans indicate that real estate markets are deteriorating in many parts of the country. Under such conditions, it is natural that the demand for real estate-related loans should decline. A recent report by the Conference Board indicates, and I quote:

> Given the current state of the economy, business demand for bank credit should be expected to be low.

The report suggests that any slowdown in debt is perhaps more a reflection rather than a cause of a slowdown in the economy. A survey by the National Federation of Independent Business supports this conclusion by reporting that fewer and fewer small businesses are seeking credit. To quote William Dunkelberg, chief economist at the Federation and a professor of economics at Temple University, and again I quote:

> Small businesses are borrowing at low levels, but that's because they don't need it or don't they want it.

In our view, banks are to be applauded for tightening credit standards.

A recent Washington Post article, entitled, "Credit Crunch Threatens Small Business," reported that small, troubled and unestablished businesses and unprofitable companies are currently experiencing difficulty in obtaining, expanding or renewing credit lines.

We think applying traditional prudent lending standings to these kinds of borrowers is a sound practice. Tightening standards does not mean that marginal borrowers are perfunctorily denied loans.

It means that bankers are requiring borrowers to provide support for the loans. Bankers are asking for demonstrated payment records, profitability, owner-equity, and collateral.

We also hear that bankers are concerned about the issue of environmental lender liability, and are taking this into account when making credit decisions. We appreciate and support congressional efforts, such as that of Senator Garn's bill S. 2319, to limit the liability of the nonculpable lender, as well as the liability to the FDIC and the RTC. This is an important step to assure the continued availability of appropriate credit.

We recognize that some bankers are concerned that vigorous examinations, especially in weak markets like New England, are a signal to cut back lending. If this is the signal received, it is a false one.

In fact, Chairman Greenspan, Comptroller Clarke and Chairman Seidman recently requested a meeting with the board of directors of the ABA. They told the group that they expected bankers to closely scrutinize real estate loans, but they did not tell bankers to stop making loans.

Even where the economy has a slowdown, there are good loans available and those loans should be made, but we are, in fact, encouraging bankers to carefully screen their loans and pay close attention to market conditions.

In conclusion, the FDIC has no evidence of a credit crunch, per se, on either a nationwide or regional basis. However, credit contractions are occurring in areas of economic downturn. Our most recent information shows that noncurrent real estate loans are spreading from Texas and New England to other parts of the country. A credit contraction is the likely result, but this is after several years of very rapid growth, particularly in real estate development. A strong real estate market cycle downturn has resulted in a real devaluation of asset values.

Consequently, the banking industry has become more cautious. Credit may be difficult to obtain for the marginal borrower. However, there appears to be ample credit sources available to meet legitimate and viable credit needs. We are in favor of the banking industry tightening lending standards, and returning to basics. However, this tightening does not mean banks should stop making loans.

Instead, we expect and urge banks to continue making loans to good, creditworthy borrowers.

Thank you.

[The complete prepared statement of L. William Seidman follows:]

TESTIMONY OF

L. WILLIAM SEIDMAN
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

ON

CREDIT AVAILABILITY

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

10:00 A.M.
THURSDAY, JUNE 21, 1990
ROOM 538, DIRKSEN SENATE OFFICE BUILDING

Good morning, Mr. Chairman and members of the Committee. We appreciate the opportunity to address the Committee on behalf of the Federal Deposit Insurance Corporation on the timely topic of credit availability.

Our remarks will focus on the so called "credit crunch" debate. Specifically, we will address the condition of real estate markets and real estate lending by banks across the country. We will look at the region receiving the most attention -- New England. We also will review the supervisory policies and practices followed at the FDIC, and will attempt to clear up the misconceptions surrounding the term "performing non-performing loans."

CREDIT CRUNCH

To discuss the subject of a "credit crunch," we first need to know what is meant by this term. We define credit crunch as the general unavailability of credit to creditworthy borrowers, for legitimate and viable purposes. This is in contrast to the term "credit contraction" which is generally defined as a phase in a normal market real estate cycle.

What we see are mixed signals. There may be isolated instances across the country where creditworthy borrowers with viable projects to finance are being denied credit. However, we have not seen any evidence that such credit denials are anything more than isolated instances. That is, we see no signs of a credit crunch in terms of creditworthy borrowers. We are, however, seeing increasingly clear signs of a credit contraction. Real estate markets are weakening throughout the country, not just in New England. Moreover, we are seeing a downturn in certain types of real estate lending by banks.

Our first quarter data for the commercial banking industry show that the growth rate for construction and land development loans dropped to zero. That is, after years of steady increases, total construction and land development loans remained constant in the first quarter. However, other types of real estate lending continue to show normal growth. Commercial real estate lending continues at a 12 percent annual growth rate. Home mortgage loans and mortgage-backed securities grew at almost the same annualized rate in the first quarter. (See Chart 1). In fact, real estate lending continues to account for an increased portion of overall bank lending. About 40 percent of all bank loans are real estate related. In addition, while total bank assets increased by only 5.1 percent from the first quarter of 1989 to the first quarter of 1990, real estate loans increased by 11.8 percent over the same period.

Greater dependence by banks on real estate lending comes at a time when real estate markets are weakening not just in New England but across many parts of the country. As of year-end 1989 there were 20 states where banks had noncurrent real estate loans that exceeded two percent of total real estate loans. Only three months later, our first quarter data show 28 states where the percentage of noncurrent real estate loans exceed two percent. More than half of these states have a noncurrent ratio of three percent or higher. (See Chart 2).

The first quarter figures on noncurrent real estate loans indicate that real estate markets are deteriorating in many parts of the country. Under such conditions it is natural that the demand for real estate related loans should decline. A recent report by the Conference Board indicates that "given the current state of the economy ... business demand for bank credit should be expected to be low." The report suggests that any slowdown in debt is perhaps more a reflection rather than a cause of a slowdown in the economy. A survey by the National Federation of Independent Business supports this conclusion by reporting that fewer and fewer small businesses are seeking credit. To quote William Dunkelberg, Chief Economist at the Federation and a Professor of economics at Temple University, "Small businesses are borrowing at low levels, but that's because they don't need it or don't want it."

NEW ENGLAND BANKING ENVIRONMENT

The New England region is undergoing a strong credit contraction as a result of overbuilding and a declining economy. Construction lending in the Boston area declined 13.2 percent in 1989, overdue and nonaccrual real estate loans grew 245.3 percent to 1.9 percent of bank assets, and repossessed real estate leaped by 180.8 percent. A recent American Banker listing of the largest banks (assets over $500 million) with the highest ratio of noncurrent and nonaccrual real estate loans as a percentage of capital showed 13 New England institutions among the worst 25. (Of the balance, six were in Texas, three in Arizona, two in Florida and one in New Jersey.)

The regional decline appears to be a market correction caused by several years of a strong economic boom fueled in part by overcapacity in banking. Banking capital expanded significantly with the conversion of a sizable number of institutions from mutual to stock ownership. Concomitant with the capital increase was pressure from shareholders to leverage this capital by lending in order to achieve an acceptable market return.

The boom unfortunately was too often aided by liberalized lending terms and relaxed credit standards. These policies led to high loan demand, primarily in real estate development, which was funded by a combination of high cost purchased funds and consumer funds. The easy, though costly, availability of credit to both established and marginal borrowers led to severe overbuilding and a general overpricing of goods and services throughout the region. This is a common occurrence during boom periods. Other market forces -- such as setbacks in the financial services industry in the aftermath of the 1987 stock market crash, a maturing of the high tech industry, and slowdowns in defense spending -- have caused a substantial slowdown in the region's economy.

Much of the asset quality problems in New England are lodged in the banks which underwent the strongest growth during the boom years.

Many of these banks are among the region's largest. The asset quality problems have caused significant decreases in banking profits and asset valuations. Whether the losses have been recognized voluntarily by the industry or are regulator-induced through the examination process is really not the point. The asset devaluations, with rare exceptions, are proving to be valid and could in fact be understated if the region's economy continues to erode.

In order to maintain compliance with capital requirements, many affected banks have found it necessary to retrench through a shrinkage in size. This is not an uncommon scenario under the circumstances. As a result, there has been a general contraction in the availability of credit funds in these institutions.

Statistics bear this out. Loan volume in New England fell by $5.8 billion in the first quarter. Of that amount, $2.4 billion was due to loan sales and charge-offs. Thus, the net contraction in loan volume was $3.4 billion. This is not an alarming contraction, especially since loan demand also has slackened significantly throughout the region, reducing the overall need for credit. In the face of an economic slowdown, creditworthy borrowers in many instances are unwilling to borrow funds and risk capital.

The New England banking industry has tightened credit standards in a normal reaction to the general downturn in economic conditions, the overhang of properties held by the Resolution Trust Corporation and the rising level of loan problems. These tightened standards are not new, but a return to the prevalent credit standards in place before the boom years. A number of annual and quarterly financial reports being issued by these banks use the term "back to basics" in the management discussion section of the reports.

A more conservative lending posture has no doubt resulted in many marginal borrowers, particularly real estate developers, finding credit availability curtailed. This may have helped create a general perception of a credit crunch. Some proof of this is from the credit call-in line of the Massachusetts Business Corporation, an association of area lenders formed to help borrowers find credit. In March of this year the Massachusetts Governor's office began publicizing the association's phone number and inquiries increased from about 25 to 100 per week, mostly from borrowers at failed institutions. The number of calls is relatively small considering the economic base of the state.

Even though there is unquestionable weakness in banking conditions in New England, we do not see a repeat of what has occurred in the Southwest. At present, there are 60 problem banks and 14 problem savings associations among the 715 banks and savings associations in our Boston region. This is in line with the national average of problem institutions to total institutions.

BANK LENDING PRACTICES

In our view, banks are to be applauded for tightening lending standards. A recent Washington Post article titled "Credit Crunch

Threatens Small Business" gives some examples of the kind of borrowers who are experiencing difficulty in obtaining, expanding or renewing credit lines. These include small, troubled and unestablished businesses, companies that are suddenly unprofitable, and "the ones that are shaky." Applying traditional prudent lending standards to this kind of borrower is a sound practice.

Tightening standards does not mean that marginal borrowers are perfunctorily denied loans. It means that bankers are requiring borrowers to provide support for the loans. Bankers are asking for a demonstrated payment record, profitability, owner's equity and collateral. Most of us find it unpleasant to break bad news to someone and bankers are no exception. Placing blame on the examiners or regulators for rejecting loan requests or insisting on better collateral, documentation and other support before advancing funds is one way to mollify an important past and future customer.

We are also hearing that bankers are very concerned about the issue of environmental lender liability and thus take this into account when making credit decisions. We appreciate and support congressional efforts, such as Senator Garn's bill, S. 2319, to limit the liability of both the nonculpable lender and of the FDIC and the RTC. This is an important step to assure that appropriate credit continues to be available.

FDIC SUPERVISORY POLICIES AND PRACTICES

We recognize that some bankers are concerned that vigorous examinations, especially in weak markets like New England, are a signal to cut back on lending. If this is the signal received, it is a false one. We recently took unprecedented action to dispel any misconceptions or misunderstandings that may exist. The message was delivered at a meeting we requested with the board of directors of the American Bankers Association at its Washington headquarters by Federal Reserve Board Chairman Greenspan, Comptroller of the Currency Clarke and myself. We told the group that we expect bankers to closely scrutinize real estate loans but did not tell bankers to stop making loans. Even where the economy has a slowdown, there are good loans available and those loans should be made. But we are encouraging bankers to carefully screen their loans and pay close attention to market conditions.

"PERFORMING NON-PERFORMING LOANS"

The press has reported that examiners are adversely classifying performing loans. The terminology used is "performing non-performing loans." The term "performing non-performing loans" is a misnomer and is not used officially at the banking agencies. We are even removing the word "nonperforming" from official FDIC literature to alleviate semantic problems.

Instead, the terms "overdue," "nonaccrual," and "adversely classified" are the more common modifiers of troubled debt. Historic definitions of overdue and adversely classified have been developed as part of the examination process. Definitions of nonaccrual loans have been formalized in accounting instructions. A bank is not to accrue interest on (1) any asset which is maintained on a cash basis because of deterioration in the financial position of the borrower, (2) any asset upon which principal or interest has been in default for a period of 90 days or more unless it is both well secured and in the process of collection, or (3) any asset for which payment in full of interest or principal is not expected. The third definition is important in understanding the agencies' historic handling of loans which are performing but which may not be paid in full.

"Performing non-performing loans" are best described by outlining a typical loan which may fit the category. Assume 100 percent financing of the construction of an income producing property for which no secondary source of repayment is offered. The initial advances provide for the interest payments during the construction period and possibly for a short-term bridge loan after construction is completed. During the life of the loan, it is found that the assumptions used to make the initial appraisal of the property are no longer correct. For instance, rental rates may be lower than expected, operating expenses may be higher than projected, or initial occupancy is lower or slower than anticipated. These or other adverse changes in assumptions mean that a more realistic appraised value of the collateral may be less than the amount of the loan outstanding. In the meantime, the interest reserves included as part of the initial loan are used to keep the loan current or performing. In the absence of a source of payment separate from the project, the full repayment of the principal is unlikely.

Therefore, based on the instructions, this loan would be placed on a nonaccrual status and all payments received would be applied as a principal reduction. The supervisory response to this type of loan has been constant for a number of years. The loan would be considered to be in a nonaccrual status. The shortfall between the loan amount and the current collateral value, assuming no other source of payment, would be recommended for charge-off and the balance would be listed as having more than ordinary risk.

A loan of this type is speculative in nature. When assumptions used in this type of venture prove to be incorrect, the most prudent course of action is to recognize the losses inherent in the asset. This does not represent a toughening of supervisory standards but the continuation of a traditional supervisory stance.

CONCLUSION

We have no evidence of a credit crunch on either a nationwide or regional basis. However, credit contractions are occurring in areas of economic downturn. Our most recent information shows that noncurrent real estate loans are spreading from Texas and New England to other parts of the country. A credit contraction is the likely result -- but this is after several years of rapid growth, particularly in real estate development. A strong real estate market cycle downturn has resulted in a real devaluation of asset values, which has turned the banking industry cautious. Credit may be difficult to obtain for marginal borrowers. However, there appears to be ample credit sources available to meet legitimate and viable credit needs.

We are in favor of the banking industry tightening lending standards, and returning to basics. However, this tightening does not mean banks should stop making loans. Instead we expect and urge banks to continue making loans to creditworthy borrowers.

Chart 1

Real Estate Asset Growth Rates 1985 - 1990

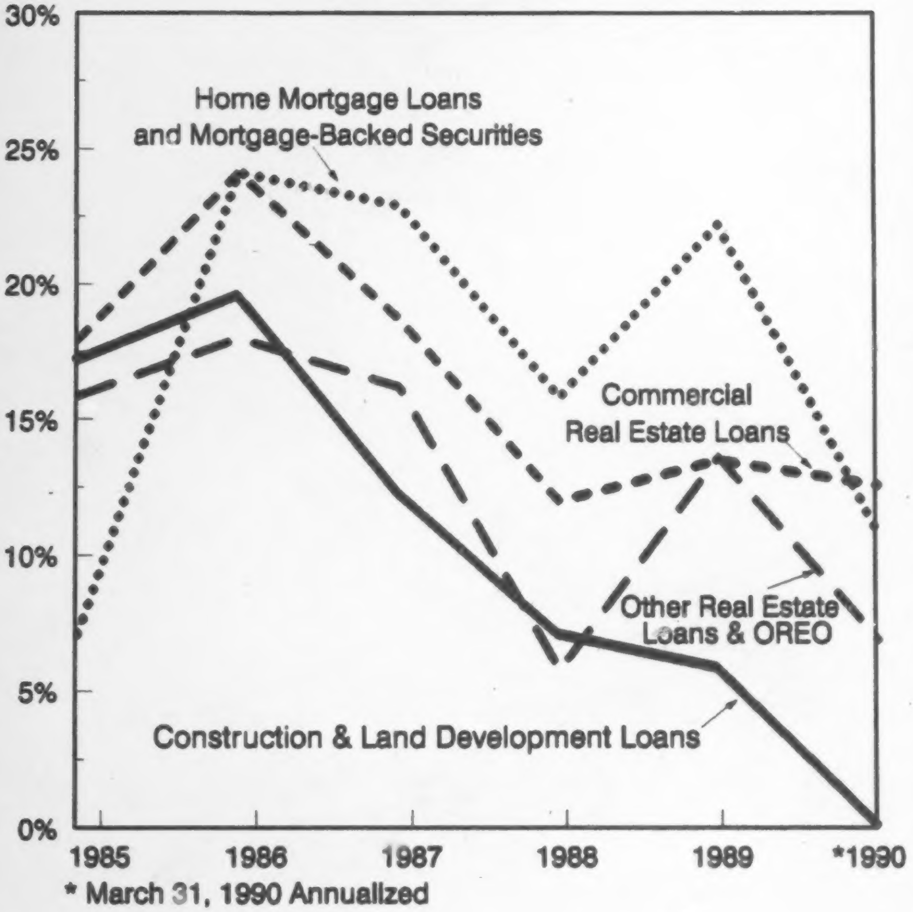
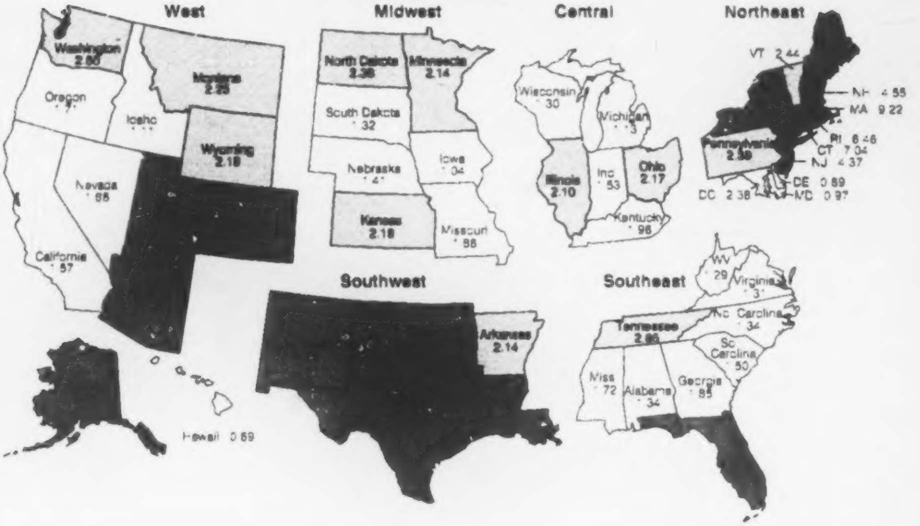


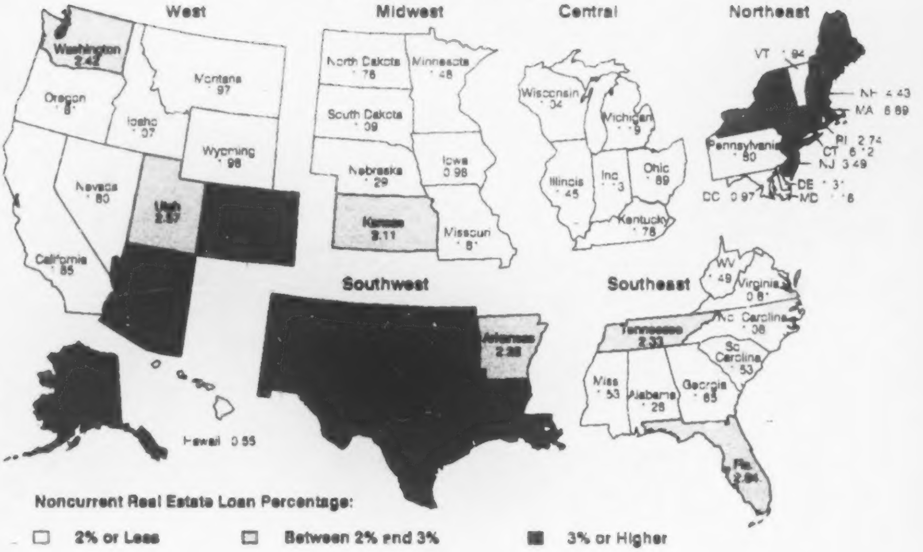
Chart 2

Noncurrent Real Estate Loan Rates by State

March 31, 1990


West
Midwest
Central
Northeast
Washington 2.80
Montana 2.25
Oregon
Idaho
Wyoming 2.18
Nevada 1.66
California 1.57
Hawaii 0.69
North Dakota 2.36
Minnesota 2.14
South Dakota 1.32
Nebraska
Iowa 1.04
Kansas 2.18
Missouri 1.56
Wisconsin 1.30
Michigan
Illinois 2.10
Ind 1.53
Ohio 2.17
Kentucky 1.96
VT 2.44
NH 4.55
MA 9.22
RI 6.46
CT 7.04
NJ 4.37
DE 0.89
MD 0.97
DC 2.38
Pennsylvania 2.39
Southwest
Arkansas 2.14
Southeast
WV 1.29
Virginia
NC Carolina 1.34
Tennessee 2.86
SC Carolina 1.50
Miss 1.72
Alabama 1.34
Georgia 1.85

December 31, 1989


West
Midwest
Central
Northeast
Washington 2.42
Oregon
Montana 1.97
Idaho 1.07
Wyoming 1.98
Nevada 1.80
Utah 2.37
California 1.85
Hawaii 0.55
North Dakota 1.76
Minnesota 1.48
South Dakota 1.09
Nebraska 1.29
Iowa 0.98
Kansas 2.11
Missouri
Wisconsin 1.04
Michigan
Illinois 1.45
Ind
Ohio 1.89
Kentucky 1.78
VT 1.94
NH 4.43
MA 6.69
RI 2.74
CT
NJ 3.49
DE
MD
DC 0.97
Pennsylvania 1.80
Southwest
Arkansas 2.28
Southeast
WV 1.49
Virginia
NC Carolina 1.08
Tennessee 2.33
SC Carolina 1.53
Miss 1.53
Alabama 1.28
Georgia 1.65
Fla. 2.84
Noncurrent Real Estate Loan Percentage:
☐ 2% or Less
▨ Between 2% and 3%
■ 3% or Higher

The **Chairman**. Thank you very much, Mr. Fritts, for a direct statement, and a great job of standing in for Bill Seidman.

Mr. Clarke, I know you had a meeting several weeks ago with some of the large banking organizations to discuss this issue. There were numerous reporting about that meeting. I know it was a private meeting, but, I trust that in your remarks today, you will give us some sense of the messages you delivered in that meeting and in others. We are delighted to have you, and would like to hear from you now.

STATEMENT OF ROBERT CLARKE, COMPTROLLER OF THE CURRENCY, WASHINGTON, DC

Mr. **Clarke**. Thank you, Mr. Chairman. It seems as though the saying that a day without a meeting with bankers or borrowers is a day without sunshine has lately been true. This has been a regular occurrence.

I am delighted to be here before this group. As the agency that is responsible for supervising the Nation's 4,200 national banks, the Office of the Comptroller of the Currency [OCC] is, of course, vitally interested in maintaining a safe and sound banking system to serve the continuing credit needs of the American public. Rather than repeating my written statement that you have incorporated in the record, I think it is important to discuss with the committee this morning several widely broadcast misconceptions about what the OCC does, and why we do it.

Mr. Chairman, we have all heard or read about the concerns of borrowers, including real estate developers and persons who run small businesses, who believe that they are being denied credit that they would have easily received in the recent past. We have also heard some bankers assert that the OCC has tightened the standards used to examine lending practices, or has changed its policies, has unreasonably declared loans to be nonperforming, and has forced banks to cut back on lending, even to healthy businesses.

Because of these concerns and the need to clarify some of the misconceptions, which I agree with Senator Sarbanes, exist in the marketplace, I have over the last several weeks met frequently with groups of bankers and groups of borrowers. Just yesterday, I met with the National Realty Committee, an organization composed of major real estate developers around the country, and I discussed with them various elements that I believe have contributed to the current climate of concern. With your permission, I would like to insert into the record a copy of my remarks to that group.

The **Chairman**. We will be happy to have them.

Mr. **Clarke**. It is representative of the sorts of things that I have been saying.

The **Chairman**. Very good. We will make them a part of the record.

NEWS RELEASE

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

NR 90-98

For: IMMEDIATE RELEASE

Date: JUNE 20, 1990

Remarks by
ROBERT L. CLARKE
Comptroller of the Currency

before the
Annual Meeting
of the
National Realty Committee

Washington, D.C.
June 20, 1990

It is not often that I feel like John D. Rockefeller. But lately, my feelings have become not unlike those of the great financier when he was accosted outside his office by a smooth-talking panhandler who announced: "Mr. Rockefeller, I hiked 50 miles down here just to meet you, and everybody I met along the way assured me that you have the reputation of being the most generous man in New York."

Rockefeller thought this over for a minute, then asked quietly: "Are you going back by the same route?"

The panhandler answered: "Probably."

"Aha," said John D., "in that case you can do me a great favor. Deny the rumor."

There is a rumor afoot in the land that I'm the regulator from hell. The rumor is not true. I'm not from hell -- I'm from Texas. There may be superficial similarities between the two -- some people say that they share the same climate -- but one thing that distinguishes the people in Texas is that they are not resigned to their fate. To a Texan, problem conditions are hurdles to overcome, not eternal damnation.

And to overcome problems, you must first face up to them.

Facing up to problems is the unofficial motto of the Office of the Comptroller of the Currency.

As the agency responsible for supervising the nation's 4,200 national banks, the OCC is vitally interested in maintaining a safe and sound banking system to serve the long-term credit needs of the American public. To do that, we have to consider what happened yesterday -- if you will, to look at problems clearly and objectively. And to do that, we also have to look beyond today -- and even beyond tomorrow.

In several places across the country, developers, banks, and bank regulators alike are dealing with a major problem: real estate. This problem has been growing for some time.

Two real estate experts recently pointed out in Barron's:

"As we begin the 1990s, Wall Street and the national press have concluded that the losses reported by New England's largest banks -- the latest in a string of bad news about real estate investment -- mean that the property-market boom of the 1980s is over, and that commercial property is in for a rough time in the new decade.

"There is no doubt that the real estate market is weak today.

"However, investors in 1990 should not be surprised at the bad news because, but for a few well-publicized exceptions, the country's real estate market has been depressed for years."

They went on to say that: "information available to the investing public shows there was no sudden shock to real estate in 1989.

"Rather, weakness in the commercial real estate market was evident through the late 'Eighties.

"Statistics indicate that the supply of office space, the largest component of the nonresidential real estate market, grew faster than demand through the decade."

Now you, of all people, know of what the Barron's article speaks.

To take one example: Coldwell Banker reports that at year-end 1987, 1988 and 1989, the vacancy rates for Stamford, Connecticut, were 34 percent, 31 percent, and 32 percent, respectively.

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Clearly, in Stamford -- and elsewhere -- supply has outdistanced demand -- and it has outdistanced demand for quite a while.

Three years ago, I began talking with several of you about this problem.

The problem in real estate has caused problems in some banks. But these problems can -- for the most part -- be overcome.

Unfortunately, the climate -- some might say, the hellish climate -- at present doesn't make that task any easier. As with all climates, this one is the result of several elements and the interplay among them.

What are these elements?

Some banks that have real estate portfolio problems have found their capital in jeopardy. And some of the banks in that position have reacted by downsizing their portfolios. As perverse as it sounds, the easiest way to do that is to run off your best customers -- because these customers are in the best position to find alternative sources of financing. But until these customers find other sources they are angry -- and as we have found, some are vocal in their anger.

Add to that the fact that securities analysts focus on problems -- as they also focus on strengths. Just as the the analysts focused on bank problems with highly leveraged transactions, they have been and are focusing on bank problems with real estate. And the targets of much of their focus are those institutions with the greatest aggregate exposure to real estate. That analytical focus is another element motivating bankers to shrink real estate portfolios.

Add to these the element of the unknown: The FIRREA legislation that granted federal bank supervisors -- even though we didn't ask for it -- the authority to impose heavy fines on banks, bank officers and bank directors. We didn't ask for that authority. We've yet to impose a penalty under these new provisions, and even if we did, the due process protections we have today would apply.

But the players -- bank boards of directors and managements -- know that these penalties are now in the rule book. This knowledge is particularly disconcerting to directors, especially those directors facing our regulatory enforcement proceedings for the first time.

The unknown can be frightening and intimidating.

I know.

I used to represent bankers and directors who were in unknown situations.

Now add to that the shareholder suits against the managements of banks that are reporting losses.

With all those elements in motion, it is no wonder that bank managements are skittish.

There is one element in the climate, however, that should not be an unknown. That element is what the OCC does and why we do it. It is crucial that bankers, developers, home builders -- everyone touched by the real estate problem -- know what the OCC does and why.

And I've found it necessary to describe what we do and why we do it personally -- in meetings such as this one -- because, like John D. Rockefeller, we've found ourselves having to deal with unfounded rumor.

So I would like to discuss with you this morning several widely broadcast misconceptions.

Given this sophisticated audience, the appropriate place to begin is with the concerns of borrowers who believe that they are being denied credit that they would have easily received in just the recent past. We sympathize with the plight of businesspeople who have difficulty obtaining credit, or, in fact, may be unable to obtain credit at all, through no fault of their own. However, attempts to blame the OCC -- or other bank regulators -- for their condition are unwarranted. Critics who are linking the difficulties of some borrowers to a supposed crackdown on lending by the OCC are promoting incorrect views of what we do and how we do it -- and why.

These arguments assume that the OCC is telling banks to whom they should or should not lend. Nothing could be farther from the truth. We do not make individual credit decisions. That is what bankers are paid to do.

We haven't told bankers: "Don't make loans." We have reminded them to take care in making loans. And, we recognize that our attention to particular categories of loans, or to individual loans, has inevitably resulted in stricter loan underwriting standards. But, there is an important difference here between shutting off all credit, or all credit of a specific type, and continuing to make the good loans to creditworthy borrowers. It is the banker's job to find the good loans and to make them. And it is the banker's job to be able to justify the loan -- not just, and not even first, to the regulators -- but to the banker's own board of directors.

We haven't repealed the basic rules of banking, including the practice of bankers working with customers during economic declines. That means working with customers to restructure loans, if necessary. When OCC examiners classify a loan, they don't intend for the institution simply to walk away from the loan and the borrower.

Rather, the banker would be expected to analyze the credit and the borrower and restructure the credit where appropriate. If a loan becomes troubled, the focus of the banker's attention should be how to lose the least amount of money on the loan. And minimizing or eliminating loss may best be achieved by continuing to work with the borrower. That process has been the case historically. It is good banking.

And when we find problems in one sector -- say, real estate -- we don't intend for an institution to paint all its customers with one brush -- in other words, to assume that there will be problems in other sectors, too. We are not telling bankers to cut off credit from a good customer.

And we do not -- as some of our critics have charged -- set monetary or any other type of economic policy. That is not our job.

What is our job?

Our job of bank supervision includes three important tasks. One, we make sure that banks adopt and adhere to sound credit practices. Two, we make sure that their books accurately reflect the value of their assets and liabilities. And, three, we make sure that national banks establish management systems capable of tracking bank activities and reasonably anticipating and adjusting to changing market conditions. In other words, we expect bankers to have mechanisms in place to conduct their own asset quality reviews to search for faults. Ideally, we should then only have to check to see that the mechanisms exist and that they are performing as intended.

But in the less than ideal world in which we live, we often find faults -- in asset quality, in managerial controls, in management -- that bankers haven't recognized for whatever reason. And we do what it takes to make bankers recognize these weaknesses. That means that we encourage, coach, coax, caution, and, if necessary, compel national bankers to focus on the quality of their investments and improving that quality if they need to do so.

In a nutshell, that is bank supervision. Its goal is to make sure that bankers recognize reality. Its goal is to make sure that a banker has an understanding of his or her financial institution's condition that is true and reasonable. And its goal is to make sure that bankers make managerial decisions that reflect this true and reasonable understanding.

It is not our job to make sure that each and every bank remains in business. It never was our job to do so. Banks -- being private enterprises, not public utilities -- are in business to make money. Banks that don't make money over time go out of business.

Another misconception that is now floating around the banking community is that we have a computer model that our examination staff purportedly uses to determine credit quality in individual banks through some sort of simulation. The important point here is that we do use a model to identify -- and to prioritize for our review -- those banks which may have the most exposure to real estate. But, our examiners review loans on an individual basis by taking an in-depth look at the information available in the bank -- not through a computer model. All the computer model does is tell us where we need to send troops.

Similarly, the view held by some that the so-called "performing/nonperforming" loan is a new concept is a myth. It is not a new concept -- it has been in our call report instructions for years. Further, the mythology states that loans that are good -- that is to say, being repaid under the terms of the credit agreement -- are being criticized by bank examiners in spite of reality. Well, the loan may be performing, but in criticizing it, the examiner is recognizing reality, not denying it.

Let's look at an example of the type of loan that might be placed in nonaccrual status. A developer of an income-producing property has been able to make interest payments on the loan to keep it current -- but the developer has been doing so only by obtaining the funds from a credit source, perhaps even a loan at the same bank that underwrote the construction loan.

We have to look at the fundamentals -- as we would expect the bank to do. Is the project leasing up as expected? Are rents where they were projected? If the answers to the questions -- and others like them -- are negative, an examiner is reasonable in questioning the quality of an asset, even if it is performing, because the project itself is not capable at this point of producing enough cash flow to cover principal and interest.

To understand why an examiner questions the quality of an asset, it is helpful to keep in mind that when a local or regional economy is constantly on the rise, we do not have the same concern.

Why?

Because, for the most part, cash flow from the projects are generally at or better than projections, and debt service capacity is most often not a problem.

The related topic of guarantors has also been under much discussion. Why do we look at guarantors so carefully?

When a bank makes a construction real estate loan, the primary sources of repayment are the sale of the property or a permanent refinancing. But if the primary sources of repayment have weakened, the bank often looks to a guarantor who may guarantee all or only a part of the debt.

Prudent banking requires that the bank have all the necessary information to determine the ability of that guarantor to make payments and perform on that loan. This has been the case for years and it should come as no surprise to any banker that examiners will ask for and review information on guarantors.

I again want to stress one point: We review each loan separately and on its own merits. We judge the quality of that loan -- and nothing but the quality of that loan.

As part of the process of overall supervision, however, we also monitor economic trends that might provide some indication of emerging credit problems. When necessary, we conduct special examinations of credit categories that our routine monitoring leads us to believe call for special scrutiny. The recent real estate examinations -- which have been associated with substantial additions to loan loss reserves by a number of large banks -- have given rise to speculation that the OCC is tightening supervisory standards in an attempt to discourage additional real estate lending.

That is simply not the case. OCC examiners are applying the same rules to their credit reviews that they have applied in the past.

If our rules haven't changed, what has? The economic environment. The markets.

The economic environment in which many banks and their customers do business has has cooled or slowed over time. The deterioration, in turn, directly influences overall credit quality and the demand for credit.

We assume that prudent bankers will exercise caution in financing projects that appear to exceed the capacity of a weakening economy to absorb, even when the borrowers have good credit histories and the projects might be considered attractive lending opportunities in a more favorable economic environment. And we assume that prudent bankers will also recognize that deteriorating economic conditions can erode the value of assets already on the bank's books, thereby reducing the bank's capacity to extend new credit. Indeed the OCC's supervisory process is designed to reinforce sound decision-making by bank managers in this area.

Criticism of loans by the OCC is not the cause of credit contraction. Instead, it is an effect -- an effect of -- and a response to -- deteriorating conditions. Criticism of loans by the OCC is the recognition by bank regulators of changes in the environment that call into question the quality of loans already on a bank's books.

A softening economy may also make a bank less willing to lend to all customers.

Further, as we all know, commercial real estate lending grew tremendously at banks in the 1980s -- the growth rate in New England more than tripled. Unfortunately, the infrastructure the banks needed to support these lending activities didn't always grow accordingly. As a result, bankers now have to deal with nonaccruals and other troubled loans that take up a lot of time and manpower. So bankers can't spend as much time developing new business. Obviously, the level of real estate concentration in a bank's portfolio is a factor in determining the severity of these problems.

The message we hear repeatedly is that conditions would right themselves if we would just -- to use the popular expression -- "lighten up." Everything I've said this morning argues against that. It would not be in the interest of the banking system or the general public -- including developers -- for the OCC to ignore changes in a bank's condition that materially affect the bank's safety and soundness. Although economic conditions can place burdens on banks and their customers, it would be a mistake to respond by looking the other way when we uncover problem credits, unsound credit practices, or overstated estimates of capital adequacy.

We don't want to make the situation harder than it needs to be, but we cannot meet our responsibility to the public by closing our eyes and hoping that problems will go away. It is true that the economic environment in which our standards are applied has changed. For that reason, we give credits a closer look than we would have under more fortunate circumstances. It is a fact that a soft real estate market or a weak local economy offers fewer opportunities for sound bank loans. But bank supervisors cannot alter that fact.

As a bank supervisor, the OCC operates under the principle that -- in the long run -- economic growth must rest on a firm foundation: a safe and sound financial system, in general, and a safe and sound national banking system, in particular. We put this principle into practice through strong and appropriate banking supervision.

Our job is like that of a smoke detector: to be constantly on guard for the signs of trouble and to sound a warning if those signs appear. Needless to say, when the smoke detector goes off, you don't blame the alarm for the fire. In fact, after the flames are extinguished, you probably are thankful someone came up with the idea for the warning device.

All of us -- bank supervisors, bank examiners, bankers, developers -- all of us have a community of interest in preserving a firm foundation exists on which to build future growth. Preserving that foundation is why the OCC does what it does. If you hear otherwise, it is only a rumor.

Thank you for the opportunity to speak on this important topic. I am happy to respond to any questions.

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Mr. **Clarke.** I feel it is important for the members of this committee to know that we sympathize with the plight of small business people who have difficulty obtaining credit or who, in fact, may be unable to obtain credit at all, through no fault of their own. But blaming the OCC or any bank regulator for their condition, I believe, is unwarranted.

That line of reasoning assumes that the OCC is telling banks to whom they should or should not lend. We don't make individual credit decisions. That is what bankers are paid to do. We haven't told bankers not to make loans. We reminded them to take care in making loans. It is the banker's job to find the good loans and to make them. And it is the banker's job to be able to justify the loan, not just, and not even first to the regulator, but to the banker's own board of directors.

We also haven't repealed the basic rules of banking, including the practice of bankers working with borrowers during times of economic slowdown. And, that means working with customers to restructure loans, if necessary. When we classify a loan, we are not sending the signal that the institution should simply walk away from the loan and the borrower. Instead, the banker would be expected to analyze the credit and the borrower and restructure the credit where it is appropriate. If a loan becomes troubled, the focus of the banker's attention should be how to lose the least amount of money on the loan, and minimizing or eliminating loss may best be achieved by continuing to work with the borrower. That process has been the case historically, and I believe it is good banking.

When we find problems in one sector, real estate, for example, we don't intend for an institution to paint all of its customers with one brush—in other words, to assume that there will be problems in other sectors as well. We are not telling bankers to cut off credit to a good customer. We do not, as some of our critics have charged, set monetary or any other type of economic policy. That is not our job.

And it is not our job to make sure that each and every bank remains in business. It never has been our job to do so. Banks, because they are private enterprises, and not public utilities, are in business to make money. Banks that don't make money over time go out of business.

Another misconception that is floating around the banking community is that we have a computer model, a so-called black box, that our examination staff purportedly uses to determine credit quality in individual banks through some sort of simulation. The important point here is that we do use a model to identify and prioritize for our review those banks which may have the most exposure to real estate. But our examiners review loans on an individual basis by taking an in-depth look at the information that is available in the bank—not through a computer model. All the computer model does is tell us where we may need to take a closer look.

Similarly, the view that is held by some that the so-called "performing nonperforming" loan is a new concept is a myth. The name may be new. Always before it has been called a nonaccrual loan, but the accounting concept of nonaccrual loans is not new. It has been in our call report instructions for years, and it has been in the accounting literature for years.

This mythology also states that loans that are good, that is, to say, that are being repaid under the terms of the credit agreement, are being criticized by bank examiners in spite of reality. The loan may be performing, but in criticizing weaknesses in the loan, the examiner is recognizing reality, not denying it, as my written statement discusses in more detail.

The related topic of guarantors has also been under much discussion. Why do we look at guarantors so carefully? When a bank makes a construction real estate loan, the primary sources of repayment are the sale of the property or a permanent refinancing. But if the primary sources of repayment have weakened, the bank often looks to a guarantor who may guarantee all or part of the debt. Prudent banking requires that the bank have all the necessary information to determine the ability of that guarantor to make the payments and perform on the loan. This has been the case for years, and it should come as no surprise to any banker that examiners will ask for and review information on guarantors. Just as it should not come as a surprise to any banker that our policy is not to use liquidation values in judging the quality of a loan portfolio—mythology to the contrary.

Mr. Chairman, I just want to stress, again, one point. We review each loan separately, and on its own merits. We judge the quality of that loan, and nothing but the quality of that loan.

Now, it is true that we monitor economic trends that might provide some indication of existing credit problems, or emerging credit problems, and on the basis of these indicators we conduct special examinations of credit categories that we believe call for special scrutiny. It would be irresponsible for us to ignore the signs of potential weakness, and we would expect that bankers are doing the same thing. But this monitoring merely points us to where the weaknesses may exist. Hands-on examinations determine if the weaknesses are, in fact, there.

The recent real estate examinations which have been associated with substantial additions to loan loss reserves by a number of large banks have given rise to speculation that the OCC is tightening supervisory standards in an effort to discourage additional real estate lending. That is simply not true. OCC examiners are applying the same rules to their credit reviews that they have applied in the past.

If our rules haven't changed, and our policies haven't changed, then what has? The economic environment.

The economic environment in which banks and their customers do business has deteriorated in New England and in some other States, that is to say that the economic environment has cooled or slowed over time. The deterioration, in turn, directly influences overall credit quality and the demand for credit. My written statement discusses the deterioration in some statistical detail, as does the information provided by the other witnesses.

Criticism of loans by the OCC is not the cause of credit contraction. Instead, it is an effect—an effect and a response to, deteriorating market conditions. Criticism of loans by the OCC is the recognition by bank regulators of changes in the environment that call into question the quality of loans that are already on a bank's books.

Unfortunately, a softening economy may reduce the anticipated demand for a business's products, and a softening economy may also make a bank less willing to lend to all customers.

In addition, as we all know, commercial real estate lending grew tremendously at banks during the 1980's. The growth rate more than tripled in New England, for example. Unfortunately, the infrastructure that the banks needed to support these lending activities didn't always grow accordingly. As a result, bankers who now have to deal with nonaccruals and other troubled loans that take up a lot of time and manpower can't spend as much time developing new business. Again, because of that, business customers are concerned, and legitimately so.

We recognize that being overly stringent would have harmful effects. We do not want bankers to make changes in their credit decisions based on fear of unwarranted criticism by bank regulators. But it would not be in the interest of the banking system or the general public for the OCC to ignore changes in a bank's condition that materially affect that bank's safety and soundness. Although economic conditions can place burdens on banks and their customers, it would be a mistake to respond by looking the other way when we uncover problem credits, unsound credit practices, or overstated estimates of capital adequacy.

As a bank supervisor, the OCC operates under the principle that in the long run economic growth must rest on a firm foundation, and that foundation is a safe and sound financial system in general, and a safe and sound national banking system in particular. We put this principle into practice through strong and appropriate bank supervision. We don't want to make the situation harder than it needs to be, but we cannot meet our responsibility to the public by closing our eyes and hoping that the problems will go away. The economic environment in which our standards are applied has changed. It is a fact that a soft real estate market or a weak local economy offers fewer opportunities for sound bank loans, but bank supervisors cannot alter that fact.

Thank you for the opportunity to be here this morning to speak on this important subject.

[The complete prepared statement of Robert L. Clarke follows:]

For Release:
June 21, 1990, 10:00 a.m.

STATEMENT OF
ROBERT L. CLARKE
COMPTROLLER OF THE CURRENCY
before the
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
of the
UNITED STATES SENATE
June 21, 1990

Mr. Chairman and members of the Committee, I am here to respond to concerns that you and others have raised about the availability of bank credit. The banking system is the foundation upon which a strong economy is built. Banking supports economic growth by funding business activity. In the long run, business expansion requires a safe and sound banking system. As the agency responsible for supervising national banks, the Office of the Comptroller of the Currency (the OCC) is vitally interested in maintaining a safe and sound banking system that serves the credit needs of the American public.

Like the Committee, the OCC has heard concerns voiced by borrowers -- including real estate developers and persons who run small businesses -- who are having difficulty obtaining credit for projects and other activities that they consider sound and that they believe would have received credit in the past. We have also heard some bankers assert that the OCC has tightened the standards used to examine lending practices; has unreasonably declared loans to be non-performing and required banks to increase reserves for loan losses; and has forced banks to cut back on lending, even to healthy businesses.

I am here today to respond to these concerns by describing for you the OCC's loan review policies and recent actions, as well as the possible effect of these policies and actions on the availability of credit. We believe that the stories that link the difficulties of some borrowers in obtaining credit to a supposed crackdown on lending by the OCC are based on an inaccurate view of how the OCC supervises national banks and the effect of our examinations on the willingness of banks to make sound loans.

Before discussing OCC policies and actions, it is important to clarify exactly what the problem is. There have been numerous reports of reductions in the availability of credit. But, the limited data that has been reported by banks, periodic and special studies by the Federal Reserve System, and private surveys has indicated that, while credit has contracted somewhat in some localities, to date, the effect is not as severe as it is often portrayed. The reduction in credit appears to consist primarily of:

(1) A decline of credit extended for activities in geographic areas where demand for that activity is declining. For example, there appears to be both a decline in credit availability and credit demand for real estate construction loans in New England.

(2) An increase in collateral and guarantee requirements for loans that are particularly sensitive to changes in economic conditions, and

(3) A decline in the availability of credit from certain banks that must focus on working out the identified problems that currently exist in those banks' loan portfolios.

Such trends can be a cause for concern, but they need to be placed in perspective. Bankers must assess the strength of the local economy and assess the ability of potential borrowers to repay loans when making initial credit decisions and in monitoring and managing credits after they are made. It is appropriate and not surprising that loans that once looked attractive are now receiving closer scrutiny, for example, in areas where vacancy rates in rental properties are rising and retail sales and employment growth rates are declining.

A critical part of the OCC's mission is to ensure that national banks follow sensible credit standards when they make loans so that the banks remain safe and sound. Clearly, we must be reasonable in applying our examination policies to work with banks as they address their problems. Economic conditions can place burdens on banks and their customers which bank supervisors must recognize. However, the recent experience of the savings and loan industry is only the most recent reminder that, no matter how good our intentions, it is not in the public interest to ignore changes in banks' conditions. We cannot respond by looking the other way when we uncover problem credits, unsound credit practices, or overstated estimates of capital adequacy. If supervisors ignore problems, then positive actions to solve those problems won't be taken -- the situation will continue to deteriorate. Moreover, the importance of uninsured creditors and stockholders having accurate information about the condition of the bank is often overlooked. If the markets become unsure of the quality of bank portfolios, then investors will require substantial risk premiums, making it more expensive for all banks to raise capital.

At the same time, we recognize that being overly stringent would have harmful effects. We do not want bankers to make changes in their credit decisions based upon fear of unwarranted criticism by bank regulators. Commercial lending is a cornerstone of banking and we continue to urge bankers to make sound loans -- including real estate loans -- to qualified borrowers.

The OCC, working with officials from the Federal Reserve System and the Federal Deposit Insurance Corporation, has been taking constructive steps to explain our concerns about loan quality and to deal with possible overreaction to market conditions and regulatory scrutiny. Most notably, on May 10, Federal Reserve Board Chairman Alan Greenspan, FDIC Chairman L. William Seidman, and I met with officials of the American Bankers Association to allay fears among bankers that regulators would criticize prudent bank lending. In this meeting, we stressed that recent reviews of real estate lending at major state and national banks in New England were cooperative processes that involved examiners from all three federal bank regulatory agencies. These reviews uncovered problems that resulted in increases in criticized loans, provisions for loan loss reserves, and more loans being placed in nonaccrual status. These actions were appropriate and were warranted by the economic changes in the region. However, they were not meant to encourage banks to pull back from lending to credit-worthy borrowers. All of us expressed our belief that it is appropriate for banks to continue lending -- that qualified borrowers exist and that they represent important business opportunities.

THE ECONOMIC ENVIRONMENT

The OCC monitors the economic environment for indications of changes that may lead to supervisory problems and we encourage banks to do the same. In fact, the recent real estate examinations are only the latest in a series of steps that the OCC has taken to evaluate the steadily growing real estate loan portfolios of national banks. For example, in 1987, because of our analysis of softening real estate markets and an increased national bank participation in real estate lending, we began to review the real estate lending practices at many banks. In 1988, OCC examiners in the Southeast District examined the real estate lending practices at the regional banks in that district which had the largest exposure to real estate. They subsequently met with CEOs and members of the boards of directors of these banks to discuss the softening real estate market and the need for prudent real estate lending standards. We emphasized the need for improved standards and controls and the potential for losses if current underwriting and control weaknesses were left uncorrected.

To communicate these concerns more widely, I had an advisory letter sent later in 1988 to all Chief Executive Officers of national banks, warning them about the potential risks from excessive concentration in real estate lending. The message I delivered was that real estate lending itself does not entail undue risk. However, if proper underwriting standards are not employed, then there exists a potential for a lot of risk.

In 1989, softening regional economies, coupled with indications of overbuilding in many cities, led to increased concern by regulators about the quality of real estate loans.

Although public attention has focussed primarily on weakening real estate markets, particularly in New England, broader indicators of economic activity have also shown some signs of weakness in several regions.

- After increasing an average of 3.2 percent annually for the preceding six years, employment in New England declined slightly in 1989. Employment growth fell below one percent in the Middle Atlantic region as well, declined more modestly in the South and Midwest, and remained relatively firm in the West.

- Retail sales, adjusted for inflation, increased by only 0.6 percent nationwide in 1989, well below the 4.8 percent rate of the preceding six years. The Middle Atlantic states suffered a decline in retail sales, as did several Southern and Midwestern states.

- A major real estate analysis firm[1] has estimated that the average office vacancy rate for major cities on the eastern seaboard from Boston to Washington, D.C. has increased from 8.1 percent at the beginning of 1984 to 14.3 percent at the end of 1989. In addition, construction of new office space continues to exceed the rate of absorption, indicating that the vacancy rate may continue and that office rents, adjusted for inflation, may decline. While these trends do not necessarily imply declining rental rates or longer lease-up times, they can be an indicator of potential problems in the real estate sector.

- Office vacancy rates in major cities in other regions of the country are also high, averaging 24.4 percent in the South, 19.2 percent in the West, and 16.5 percent in the Midwest at year-end 1989. Furthermore, overcapacity is a concern in other types of commercial real estate, such as shopping malls.

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[1] Source: Coldwell Banker Commercial/Torto Wheaton Services

These trends are not projections made by regulators; they are economic facts that lenders must recognize. Each of these trends flags potential credit concerns. A prudent bank will exercise caution in financing projects that do not appear to make economic sense under current conditions. Even when the borrowers have good credit histories and the projects might be considered attractive lending opportunities in a different economic environment, they may not make sense in light of the current economic conditions in that particular market. A prudent bank will also recognize that deteriorating economic conditions can erode the value of assets already on its books, thereby reducing the bank's capacity to extend new credit. Even in economies which are fundamentally sound, overbuilding of real estate will generally result in a softness in real estate values until supply and demand are brought into better alignment.

OCC SUPERVISION

It is important, given the recent public attention to our examinations, to understand the OCC's role in reviewing a bank's loan portfolio. The OCC has not changed its supervisory policies. However, in many cases the environment in which bank examinations are being conducted has changed. The supervisory process is designed to encourage and reinforce sound decision-making by bank managers. Our job as bank supervisors includes three important tasks. One, we ensure that banks adopt and adhere to sound credit practices. Two, we ensure that their books accurately reflect the value of their assets and liabilities. And, three, we ensure that national banks establish management systems that are capable of tracking bank activities and can reasonably anticipate and adjust to changing market conditions.

As part of this process, we expect bankers to have mechanisms in place to conduct their own asset quality reviews. Ideally, an OCC examiner should then only have to check to see that the mechanisms exist and that they are performing as intended. But in the less than ideal world in which we live, we often find faults that bankers have not recognized. We do what it takes to make bankers recognize them.

We work to ensure that banks accurately report the condition of their portfolio and maintain reserves that are adequate to protect against anticipated losses. This does not mean that we are not also willing to cooperate with the bank to find methods that, while not threatening safety and soundness, enable them to work out their problems. We do not insist that banks foreclose on property nor do we discourage banks from restructuring loans to find acceptable repayment methods. In addition, if loan quality problems result in a bank's having inadequate capital, we work with the bank to help it develop and follow a credible capital restoration plan that will get it back to health.

However, supervisors must be willing to act to close banks that cannot survive in a competitive market. Like other businesses, some banks fail. Failures are not necessarily a reflection of the quality of supervision that banks receive. Indeed, if bank supervisors guaranteed that even the poorest management was able to succeed, the banking system would become very inefficient. What we must do is allow banks to fail, but in a manner that minimizes the cost to society and to the insurance fund.

Clearly, the supervisory process is complex and requires lots of judgment. Not surprisingly, there has been a great deal of confusion and misinformation about the purpose of bank supervision, the methods we employ to determine the need for an examination, the examination process, and the criteria we employ in assessing the quality of a loan portfolio. I would like to describe for the Committee how we go about our examinations.

The OCC strives to assure that a bank's management has an understanding of its financial institution's condition that is true and reasonable and that management's decisions reflect this true and reasonable understanding. Bank management must be able to support its credit decisions to its board of directors and its shareholders. So we encourage, coax, caution, and, when necessary, compel national bankers to focus on the quality of their investments and, if necessary, improve them.

Determining the Need for an Examination

One of the supervisory techniques we use is to conduct targeted examinations of credit categories that our routine monitoring of economic trends leads us to believe call for special scrutiny. A targeted examination may reflect supervisory concern about deterioration in the credit quality of a particular type of loan. But a targeted examination does not necessarily reflect that concern. It may be triggered by excessively large concentrations of credit in a single category or unusually rapid growth in one portion of a bank's portfolio, even if there were no signs of weakness in loan performance or credit quality. It indicates only that the OCC wishes to ensure that banks apply the same sound credit standards in the targeted category that we expect them to apply to all other loans.

We have conducted several kinds of targeted examinations in recent years: on loans to lesser developed countries; on loans financing highly leveraged transactions; and on real estate lending in several regions of the country. Contrary to some reports, we have not conducted targeted examinations of small business loans, nor are we currently making them the focus of any special supervisory review.

The Examination Process

In smaller banks an examination team -- an examiner in charge and a small staff -- judges the quality of the selected loans. If a bank appears to have problems that are so severe as to bring its solvency into question, the loans are then reviewed by other examiners.

In larger banking companies -- where there may be several subsidiaries and more than one supervisory agency involved in the exam -- the procedure becomes more elaborate and all the banking regulators work together. We will place an examiner in charge of the overall effort, and each of the subsidiaries under review will also be assigned an examiner to lead that work. All of the loans under review are discussed by the examiners with bank management and individual loan officers. Then, the examiner in charge of that subsidiary reviews the work and, if necessary, discusses it with other examiners-in-charge. The examiner-in-charge at the entire company will review the work on the most significant areas and loans. If the examiner-in-charge considers it necessary, the loans become the subject of further discussion among the examiners and with bank management. During this entire process, bank management has the opportunity to discuss specific loans with the examiners. Indeed, if the banker believes that the loan has been improperly classified, it is appropriate to raise questions at all levels of the review process, and I have encouraged bankers to do so.

During this review process, the examiners work with bank managers to ensure that the three goals I mentioned earlier are met: the bank has adopted and adheres to sound credit practices; the bank's financial statements accurately reflect the value of its assets and liabilities; and, the bank has established management systems capable of tracking bank activities and reasonably anticipating and adjusting to changing market conditions.

Assessing the Quality of a Loan Portfolio

As you know, recent real estate examinations have been associated with substantial additions to loan loss reserves by a number of large banks. These actions have led to concerns about the methods used by OCC examiners in determining the adequacy of a bank's loan loss reserves. In the examination process, we evaluate these reserves based upon a review of individual loans.

Our evaluations are not based upon the general application of aggregate economic assumptions to the loan portfolio.

When OCC examiners review a loan for an income producing project, they assess whether the projected cash flows from the project and from other sources of payment are sufficient to meet required payments. This determination relies largely upon the bank's own estimate of future cash flows. Obviously, to the extent that the current condition of the project is inconsistent with the bank's recorded estimates, adjustments must be made. But, for the most part, we do not impose our view of future economic conditions in projecting potential losses. Rather, we strive to reflect the reality of current conditions. To the extent that we look at market forecasting data, we use the same data and data services that the banks themselves use. For example, if a particular project is leased significantly below expected levels and office occupancy rates have fallen in the market where the project is located, then the estimated projected cash flows must be correspondingly lower. In doing this cash flow projection we typically use the bank's own recorded forecast of the ultimate occupancy rate; but in doing so, we recognize that it will take longer for the project to be leased, and we require the bank's valuation to reflect that reality.

If problems exist in a bank's lending portfolio, then prudent reporting requires some recognition of the potential loss. This is the purpose behind reserves. In the vast majority of cases in which reserves are required, the loans are not performing as expected. In some cases, the payments may be current, but in criticizing the loan the examiner is recognizing the reality that the resources are no longer there to continue to make payments.

Consider an example in which a developer has received a loan to construct and lease a new office building. If the leasing levels are not sufficient to generate cash flow which will meet principal and interest payments on the loan, it is reasonable to expect an examiner to question the underlying quality of the asset. This is true even if the borrower has been able to make interest payments on the loan to keep it current -- often investigation will show that the developer has been keeping the loan current only by borrowing the funds from another credit source, possibly even a loan at the same bank that underwrote the construction loan.

The related topic of guarantors has also been the subject of much discussion. When a bank makes a construction real estate loan, the usual sources of repayment are the sale of the property or a permanent refinancing. If the primary sources of repayment are not sufficient or are unavailable to meet the obligation, the bank must look to other sources -- often the developer or a guarantor -- to service all or part of the debt. Prudent banking requires that a bank have all the necessary information to determine the ability of that developer or guarantor to make payments and service the loan. Consequently, it should come as no surprise to any banker that examiners will ask for and review information on guarantors. Increased emphasis on the capacity of a guarantor is simple recognition of the changing environment. In a strong economy, where the underlying project has sufficient cash flow to service the debt in accordance with its terms, the financial capacity of the guarantor is less important. However, even when the condition of the guarantor is less important, the bank should still have timely information on the guarantor available and would be criticized by an examiner if it is not.

EFFECTS OF OCC POLICIES

The OCC does not make individual credit decisions; we believe that such decisions must be made by bank managers. Similarly, the OCC does not want to be involved in any way in allocating credit to particular firms or industries. Our role is limited to ensuring that banks adopt and adhere to sound credit practices, that their books accurately reflect the value of their assets, and that they establish management systems capable (among other things) of reasonably anticipating and adjusting to changing market conditions. Classifying loans necessarily involves judgment and reasonable people may disagree. But, it would be wrong to have the impression that it is this "gray area" of potential disagreement that is the central issue. There is no disagreement between bankers and examiners about the vast majority of loans that are being criticized and reserved against. They are simply not paying as the bank expected and, therefore, cannot be recorded as doing so.

Our purpose is to ensure that banks adhere to sensible credit standards that protect their safety and soundness, not to discourage banks from making loans. Prudent bankers have traditionally responded to softening economies or overbuilt markets by declining to finance projects that might have been credit-worthy in different circumstances. Unfortunately, it also appears that some bankers have reduced their lending to credit-worthy customers. While we do not believe that this problem is widespread, we are taking steps to encourage bankers not to overreact.

As our meeting with ABA officials demonstrates, we are actively engaged in communicating to bankers our concerns and intent. We are encouraging banks to make loans to credit-worthy borrowers at the same time that we are urging them to recognize the problems in their existing portfolios. I believe that this message is being heard. While some banks may be pulling back from lending, others are entering the market because they see the opportunities available to them.

CONCLUSION

I would like to conclude by repeating this message: We haven't told bankers not to make loans and we haven't told them to cut off credit from good customers. We have reminded them to take care in making loans and, where necessary, we have required banks to recognize weaknesses in their portfolios and management systems. To carry out our responsibility to maintain a safe and sound banking system, we must take these actions; it is too critical to the nation's economic well-being to leave such matters to chance.

The **Chairman**. Thank you, Mr. Comptroller. I want to welcome to the committee Timothy Ryan. This is your first appearance before us since taking over this job. I appreciate the hard work that you are doing.

That there were some differences of opinion during your confirmation proceeding is well known. But I am impressed that you have moved directly into this job and that you have been very responsive to the committee on the issues that have arisen.

I want to cite one specific example. The other day we were talking about the difficulty of getting current, up-to-date data out of OTS on what was happening with regard to the savings and loan industry's recovery. You asked to meet with us and brought your top staff. We discussed the issue. You indicated that you were having some problems yourself getting the data you wanted, and you pledged that you would see that that problem was worked out to meet everyone's needs.

And I want to cite another important example that it says something positive about the effort that you and your people are making.

I asked you to give us up-to-date figures on the percentage of losses incurred in the savings and loan industry's insurance fund that come from State chartered institutions. We have had an anomaly in the law that allowed State chartered institutions to go way off into exotic activities. The cost now falls back on the Federal Deposit Insurance System that Mr. Seidman, Mr. Fritts and others, are now responsible for overseeing and protecting.

I asked you to give me current data, and your people have worked literally around the clock to do so. This is what you have given me:

State chartered thrifts have accounted for the following percentage of total insurance losses. In 1987, 66 percent of FSLIC's losses came from State chartered thrifts. In 1988, 75 percent. The figure you have given us is 76 percent. If it is, it will probably be adjusted upward—you have also given us a tentative figure of 59 percent for January through April 1990. That figure is provisional, and I would not be surprised if it became larger, on revision.

We also asked you to go behind these numbers to determine the share of the problem due to Texas and California. You indicated that in 1987, 54 percent of the entire losses came from State chartered thrifts in just Texas and California. In 1988, 70 percent of the national losses came from State chartered thrifts in Texas and California. In 1989, 60 percent of the national losses came from State chartered thrifts in Texas and California, and your partial data from January through April 1990 indicate that 57 percent of the national losses have come from State chartered thrifts in just those 2 States. Am I citing that data correctly?

Mr. **Ryan**. You are, Mr. Chairman.

The Chairman. I think it is also fair to say that you told me this morning that you were shocked by these data, were you not?

Mr. **Ryan**. I am. That is correct, Mr. Chairman.

The **Chairman**. I think those numbers are very powerful ones. They say a lot that are not well known, partly because the data hasn't been readily available. I appreciate the effort that you and your people have made to do the analysis required to bring that data up to date. It is appreciated by the committee.

Mr. RYAN. Thank you.

The CHAIRMAN. We would like to hear from you now. We will make your full statement a part of the record and we would like your summary comments.

STATEMENT OF TIMOTHY RYAN, DIRECTOR, OFFICE OF THRIFT SUPERVISION, WASHINGTON, DC

Mr. RYAN. As you said, Mr. Chairman, this is my first appearance before the committee since my confirmation hearing. I would like to first thank you for having me appear as the last witness with therefore, a lower profile.

Second, I would like to thank all of the committee members and the staff. Over this last 2½ months I visited with all of you, and we have discussed in depth the savings and loan situation and I, again, would like to just thank you for this opportunity to visit with you and also for your support over these last few months.

As you know, my primary responsibilities relate to supervision of the thrift industry which concentrates on providing residential-related financing. Therefore, I respectfully defer to other members of this panel to address commercial credit. Their agencies and the commercial banking industry exert a much greater influence over credit availability and, therefore, they are more qualified to make the determination as to whether or not there is a credit crunch.

I will, however, discuss the current conditions in the thrift industry and the way the Office of Thrift Supervision regulates that industry, both of which may have an effect on the availability of mortgage credit.

The role of the thrift industry in supplying credit has greatly diminished. The data we have for 1989 show that the thrift industry as a whole is shrinking, and its role as a provider of credit is being sharply reduced. This shrinkage is to be expected, in part, because we have transferred over 400 institutions to the RTC since early 1989.

In addition, many thrift institutions under our jurisdiction are struggling to meet the new capital requirements imposed by FIRREA. These institutions have adopted a strategy of shrinking their asset base, thus taking them out of new loan activity.

Mortgage assets held by SAIF-insured saving institutions dropped in the second half of 1989, falling by 14 percent at an annual rate. By comparison, they grew by more than 12 percent during the same period a year earlier. The greatest reductions occurred in the purchase of mortgage securities and in sharply reduced construction lending.

A point should be made regarding the reduced role of thrifts in mortgage markets. Well capitalized institutions are still mortgage lenders. OTS has sought to encourage healthy thrifts to make loans that are consistent with safe and sound business practices.

I am aware of the committee's interest in the effect of the FIRREA-mandated loans to one borrower limits, and in particular whether OTS plans to provide some form of additional transition relief to healthy institutions. Many of the effects of the new limits have been mitigated by the passage of time and by our application of the Office of Comptroller of the Currency's rules.

Specifically, we have used OCC's rule that allows funding to the pre-FIRREA limits of a legally binding, conforming loan commitment that was entered into, but not funded, prior to FIRREA's enactment.

In addition, we have advised savings institutions that a loan renewal will generally not be regarded as a new loan provided no new funds are advanced, a new borrower is not substituted for the original, and every effort has been made to bring the loan into compliance.

Finally, we have applied the OCC rule that generally excludes from the lending limits financings to facilitate the sale of real estate that a thrift has taken possession of through foreclosure.

We are discussing with the Treasury Department a draft regulation which would provide additional transition relief from the loans to one borrower limit. We believe safety and soundness considerations dictate that any such relief be granted only to strong thrifts which meet the full capital requirements of FIRREA, and only for a limited transition period.

We expect a final decision on this regulation very soon.

Mr. Chairman, you have asked whether OTS examination policies have changed in ways that have caused credit to tighten. Although economic conditions may have changed, OTS's national policies, practices and standards with respect to asset review and classification have not changed since the passage of FIRREA.

The primary elements of the system were implemented in 1986 and were modeled after the practices of the bank regulators. The OTS asset classification system is designed to gauge the risk of loss to the lender, and to require appropriate loan loss allowances.

Without frequent on-site evaluations of asset quality, it is impossible to determine accurately a thrift's profitability and its true capital position. In addition, timely identification of weaknesses helps limit the magnitude of problems and encourages thrift management to take appropriate corrective actions. It is reasonable to assume, however, that in practice examiners have become more cautious in their asset classifications because they have gained valuable experience from analyzing unprofitable portfolios at failed institutions. Furthermore, our field staff have improved their judgment and now employ more sophisticated analysis techniques than in the past.

If a tightening of credit is perceived within the thrift industry, it is not due to a conscious change in examination practices since the passage of FIRREA. Legislative changes such as the loans to one borrower restrictions and a more rigid capital requirement, and economic downturns have had a more direct impact on credit availability.

As a result of these changes, the industry as a whole is engaged in a major restructuring of its balance sheets to improve its capital-to-assets ratio in an effort to survive under the new environment imposed by FIRREA.

Thank you, Mr. Chairman.

[The complete prepared statement of Timothy Ryan follows:]

STATEMENT OF

TIMOTHY RYAN, DIRECTOR

OFFICE OF THRIFT SUPERVISION

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

U.S. SENATE

JUNE 21, 1990

Thank you for the opportunity to appear before the Committee today to discuss credit availability. You have asked me to address the question of whether we are experiencing a credit crunch and whether the OTS has changed its examination practices and policies in ways that have reduced the availability of credit.

Is There A Credit Crunch?

As you know, my primary responsibilities relate to supervision of the thrift industry, which concentrates on providing residential-related financing. I will, therefore, respectfully defer to other members of this panel to address commercial credit. Their agencies and the commercial banking industry exert much greater influence on credit availability and, therefore, they are more qualified to make the determination as to whether or not there is a credit crunch. I will, however, discuss the current conditions in the thrift industry, and the way OTS regulates that industry, both of which may have an effect on the availability of mortgage credit.

Thrift Industry Lending Practices

The role of the thrift industry in supplying credit has greatly diminished. Data we have for 1989 show that the thrift industry as a whole, is shrinking, and its role as a provider of credit is being sharply reduced. This shrinkage is to be expected in part because we have transferred over 400 institutions to the RTC since early 1989; until these institutions are resolved by the RTC, this segment of the industry cannot be expected to be active lenders. In addition, many thrift institutions under our jurisdiction are struggling to meet the new capital requirements imposed by FIRREA. These institutions have adopted a strategy of shrinking their asset base, thus taking them out of new loan activity.

In particular, mortgage assets held by SAIF-insured savings institutions dropped in the second half of 1989, falling by 14 percent at an annual rate. By comparison, they grew by more that 12 percent during the same period a year earlier. The greatest reductions occurred in the purchase of mortgage securities and in sharply-reduced construction lending.

A point should be made regarding the reduced role of thrifts in mortgage markets. Well capitalized institutions are still active mortgage lenders. OTS has sought to encourage healthy thrifts to make loans that are consistent with safe and sound business practices.

Loans-to-one-Borrower Limits

I am aware of the Committee's interest in the effect of the FIRREA-mandated loans-to-one-borrower limits and, in particular, whether OTS plans to provide some form of additional transition relief to healthy institutions. Many of the effects of the new limits, however, have been mitigated by the passage of time and by our application of the OCC's rules. Specifically, we have used OCC's rule that allows funding to the pre-FIRREA limits of a legally binding, conforming loan commitment that was entered into--but not funded--prior to FIRREA's enactment. In addition, we have advised institutions that a loan renewal will generally not be regarded as a new loan provided no new funds are advanced, a new borrower is not substituted for the original obligor and every effort has been made to bring the loan into compliance. Finally, we have applied the OCC rule that generally excludes from the lending limits financings to facilitate the sale of real estate that a thrift has taken possession of through foreclosures.

We are discussing with the Treasury Department a draft regulation which would provide additional transition relief from the loans-to-one-borrower limit. We believe safety and soundness considerations dictate that any such relief be granted only to strong thrifts which meet the full capital requirements of FIRREA and only for a limited transition period. Also under analysis and discussion is the legal foundation under FIRREA for granting any such relief. We expect a final decision on this regulation very soon.

OTS Examination Procedures

Mr. Chairman, you have asked whether OTS' examination policies have changed in ways that have caused credit to tighten. Although economic conditions may have changed, OTS' national policies, practices, and standards with respect to asset review and classification have not changed since the passage of FIRREA in 1989. The primary elements of this system were implemented in 1986 and were modeled after the practices of the Federal banking regulators. The OTS' asset classification system is designed to gauge the risk of loss to the lender and to require appropriate loan loss allowances.

Without frequent on-site evaluations of asset quality, it is impossible to determine accurately a thrift's profitability and its true capital position. In addition, timely identification of weaknesses helps limit the magnitude of problems and encourages thrift management to take appropriate corrective actions.

It is reasonable to assume that in practice examiners have become more cautious in their asset classifications because they have gained valuable experience from analyzing unprofitable portfolios at failed institutions. Furthermore, our field staff have improved their judgment and now employ more sophisticated analysis techniques than in the past.

Conclusion

If a tightening of credit is perceived within the thrift industry, it is not due to a conscious change in examination practices. Legislative changes such as the new loans to one borrower restrictions and more rigid capital requirements and economic downturns have had a more direct impact on credit availability. As a result of these changes, the industry as a whole is engaged in a restructuring of its balance sheets to improve its capital-to-assets ratio in an effort to survive under the new environment imposed by FIRREA.

The **Chairman**. Thank you, Mr. Ryan. We appreciate that testimony that you have given us this morning.

I want to go immediately to you, Mr. Greenspan. In his testimony, which Mr. Fritts has so ably delivered, Mr. Seidman defines a credit crunch as follows. I quote him, "The general unavailability of credit to credit-worthy borrowers for legitimate and viable purposes."

Now, Secretary Mosbacher and Secretary Kemp have both said within the last week that we are in a credit crunch. They have been very explicit about it. Using this definition of Mr. Seidman's, I want to ask you, do we have a credit crunch or not?

Mr. **Greenspan**. First of all, let me say I do subscribe to Mr. Seidman's definition. My concern about this issue is that it is a very complex process, and individuals can choose words differently to describe it. That there is a problem I think goes without saying.

What is the nature of the problem, and how one defines it, is quite important. Taking the definition, which I subscribe to, I say the answer is, no, not yet. It may emerge, but the evidence that we see to date does not suggest that particular phenomenon. If it were existing at this stage, we would suspect to see it in a number of elements within the financial structure, including as I indicated in my prepared remarks, significant opening up of yield spreads on private instruments versus Government instruments which, of course, we do not see.

Having said that, I would scarcely want to argue that we don't have some problems in the credit markets. Obviously, we do. But I think it is important for us because this is such a difficult problem to be very careful in how we choose to characterize it, because I don't think we can make progress in this issue of trying to understand what is happening unless we divide the issue in a very important way as to causation, and I must say I thought that Chairman Seidman's endeavor to do that was, I thought, quite helpful.

The **Chairman**. I appreciate the directness of your answer, Chairman Greenspan.

Mr. Fritts, I am concerned about the amount of money in the bank insurance fund, and I am concerned about the difficulties I see in the banking system. We have got some rather clearly identified problems there and possibly some others to come.

I want to ask you whether or not we are going to need to raise the commercial bank insurance premiums any time within the next year to sustain the bank insurance fund at a minimally acceptable level?

Mr. **Fritts**. Well, Mr. Chairman, the fund is clearly under some pressure as anyone who reads the paper or follows the FDIC's financial statements, I am sure already realizes.

That said, I think a lot depends on exactly what does happen to the real estate markets. If we have seen about the worst of the decline in values, and there have been some decline in values, I think the Fund can sustain itself without any additional premium.

If one wanted to error on the side of conservatism, which someone mentioned earlier, obviously more is better. There are uncertainties out there. We don't see anything certainly in the near term that is threatening to our fund in any way.

On the other hand, if a big bank should fail that would place additional pressure on the fund, that is certainly something we ought to be looking at and we intend to do that.

The CHAIRMAN. Now, I take it that the balance in the fund is somewhere around $12 to $13 billion right now. Is that correct?

Mr. FRITTS. That is correct.

The CHAIRMAN. And that supports outstanding liabilities of what figure, roughly?

Mr. FRITTS. Well, it is about seven-tenths of 1 percent, whatever that figures out. About $4 trillion, roughly.

The CHAIRMAN. So, the $12 to $13 billion supports about $4 trillion? Did I understand you correctly?

Mr. FRITTS. I believe that is correct. But in any event, it is seven-tenths of the total deposits—of insured deposits. Excuse me, about $1.7 trillion.

The CHAIRMAN. One point seven trillion of insured deposits is protected at this moment by a cushion of about $12 to $13 billion. Do I have that right?

Mr. FRITTS. Well, you have that right, except you are missing a very, very important equation, and that is the capital in the system.

The capital in the system erodes before the insurance fund gets attacked.

The CHAIRMAN. I understand. But if we were to lose a big bank or more than one big bank, their capital would have disappeared and you would have to take some money out of the insurance fund in that situation.

Senator SHELBY. I wonder if the chairman would yield on that one particular point.

The CHAIRMAN. I will in just one second. I want to be sure that if this real estate softening problem continues to expand, as it appears to be doing, if we start to see additional problems building up in the banking system, if it becomes obvious that the insurance fund is under real pressure, that we would get an early warning signal from you. I would expect corresponding policy changes, relating for example, to bank dividends—policy changes to reduce banks dividends and raise insurance premiums to give us an adequate cushion.

We really have to be very careful in monitoring the size and the sufficiency of the bank insurance fund.

It looks to me that the pressures now are different and more severe than we have seen in some time.

Mr. FRITTS. Mr. Chairman, I can assure you that that is a topic that is discussed very, very frequently at the FDIC, and we are totally aware of where we stand, we are totally aware of the sensitivity of this committee as well as all of Congress on the level of the insurance fund and if, in fact, that need is relatively clear, we will be the first ones up here.

The CHAIRMAN. Senator Shelby?

Senator SHELBY. I just wanted to follow up on that one point. You have got $13 billion more or less in the insurance fund. How much capital is out in the 4000 banks, roughly?

Mr. FRITTS. Well, let's see. About $230 billion.

Senator Shelby. $230 billion. You add that to that to underpin the whole thing. Is that what you are alluding to?

Mr. Fritts. Correct.

Senator Shelby. OK. Thank you for yielding.

The Chairman. That is an important addition. $240 billion of capital that is out there provides a private sector cushion or margin of safety, in addition to the insurance fund. How much in total outstanding liabilities does it cover?

Mr. Fritts. One point seven trillion BIF-insured.

The Chairman. One point seven trillion is resting on that cushion. I do not say that it is not adequate. One hopes and trusts that it is. That is something that professionals like you have to evaluate.

If you were to see a material erosion in the insurance fund first, or a diminution of the bank capital from writing down bad loans, or some other cause we would want to follow and monitor that very development, very closely.

Mr. Fritts. And we are doing that.

The Chairman. Senator Garn reminds us all that the second round of a vote on the Senate floor is just starting. We must excuse ourselves and go and vote. We will recess for 10 or 12 minutes. We will come back immediately upon the conclusion of that vote, and we will continue then.

So, the committee stands in recess for about 10 to 12 minutes.

[Recess.]

The Chairman. Let me invite all those in the room to find a seat. We want to resume. We appreciate the patience of our witnesses. We have been joined by Senator Dodd, who has a keen interest in this subject. Senator Dodd, let me now call on you for any initial comment you want to make.

Senator Dodd. Well, thank you, Mr. Chairman. I ask unanimous consent that a prepared statement be included in the record.

The Chairman. Without objection.

OPENING STATEMENT OF SENATOR DODD

Senator Dodd. I want to first of all thank Bob Clarke. He very graciously went through a grilling, to put it mildly, in Connecticut a couple of days ago with a large audience of people who made up a pretty substantial percentage of the business community in the State of Connecticut, who expressed in I think clear terms their concerns about the credit crunch as they see it, and appreciate I think as well the job that the Office of the Comptroller has to deal with.

I think there is a sense of balance and understanding of how difficult that job can be and, obviously, everyone wants to avoid the kind of difficulties that have occurred in the past in other parts of the country.

The concern is, and I know it has been expressed by others here this morning, that the lending institutions understand that it is not the job of the Office of the Comptroller to discourage the extension of credit. In fact, quite the contrary. To be risk takers, to be responsible risk takers.

But the realities are, the perception is, and I am repeating what was said the other day in Connecticut, but the perception seems to be within the lending community that this is not the attitude, and I think that is the nub of the problem, in a sense, to make it clear that the agencies are not in the business of discouraging that activity, but the facts are that is what is occurring.

Not to be anecdotal, but Mr. Chairman, cases were cited where, and were told quite candidly, that because the business was New England business—in the case of one individual who had sought financing through thirty different financial institutions outside of the New England region were turned down by twenty-six, and in almost every instance were told because it was a New England enterprise. No other reason is really given, despite the strength of the financial statements and the like.

So, there is clearly a perception that is having the effect of almost being what I would compare to is the program trading principle in a sense. It creates sort of a downward spiraling effect, a self-fulfilling prophecy in a sense, in an otherwise strong economy. It is a weakened economy for other reasons, but a highly diverse economy in New England, and I know Senator Kerry has already addressed this particular point, but a diversified economy. It has a highly skilled labor force. Certainly, like other periods of time, maybe overbuilt periodically in terms of commercial development and real estate, but nonetheless a strong economy, and we are finding the effect of the credit crunch has reached not just the real estate developer, but now is actually reaching down to the retailer, the manufacturer, the industry that business has nothing to do with, with real estate as such.

So, it is that pervasive, and our concern is that if we don't change this perception, the psychology that has taken over, that we are going to end up with a situation for totally different reasons that could end up not being unlike the situation that occurred in the Southwest, and that is not being overly dramatic, or engaging in hyperbole, it is a fact.

Occasionally if you hear from one or two people who are excessive in their rhetoric about their concerns, I think all of us sitting up here know—we have been around long enough to disregard the voices of one, two or three who engage in rhetoric that does not reflect reality.

But when you get comments literally on an hourly basis. I mean the fact that all eight members, our entire congressional delegation was present, I can't think of another example, at least in the last 10 years, when the entire congressional delegation has come together for a single meeting in the State, reflecting the kind of concerns that we are hearing from one end of our State to the other, and I know again this is not just a Connecticut reality, this has happened, of course, as well throughout the Northeast and particularly in the New England States.

So, Mr. Chairman, I appreciate very much your holding these hearings and I am anxious to see if today we can't in addition to addressing the specific questions, begin to reverse the psychology, so there is an opportunity to do the job that needs to be done, done effectively, but simultaneously encourage the responsible borrower to go to that window and the responsible lender to extend that credit even when it is not a perfect deal, as such. That is not the purpose.

So, again, I thank you for allowing me to comment.

[The complete prepared statement of Senator Dodd follows:]

OPENING STATEMENT OF SENATOR CHRISTOPHER J. DODD
AT THE BANKING COMMITTEE HEARING ON CREDIT AVAILABILITY

JUNE 21, 1990

MR. CHAIRMAN, I APPRECIATE YOUR TIMELY SCHEDULING OF THIS HEARING IN RESPONSE TO A REQUEST FROM MYSELF AND SENATORS KERRY, D'AMATO AND HEINZ. THE QUESTION OF WHETHER OUR ECONOMY IS EXPERIENCING A CREDIT CRUNCH IS A CRUCIAL ONE NOT ONLY FOR NEW ENGLAND BUT FOR THE NATION AS WELL, AS THE DOWNTURN IN LENDING THAT IS OCCURRING IN OUR REGION IS BEING REPEATED IN THE MIDDLE ATLANTIC STATES AND ELSEWHERE. INAPPROPRIATE RESTRICTIONS ON BANK LENDING COULD CAUSE A RECESSION THAT WOULD HAVE DISASTROUS CONSEQUENCES FOR OUR ECONOMY AS A WHOLE.

ARE WE EXPERIENCING A CREDIT CRUNCH, OR MERELY A NATURAL CONTRACTION AS NEW ENGLAND COMES OUT OF A LONG PERIOD OF BOOM ? I DON'T KNOW THE ANSWER; THAT IS WHY WE ARE HERE TODAY. BUT I DO KNOW THAT AT NO OTHER TIME IN MY CONGRESSIONAL CAREER HAVE I EXPERIENCED SUCH AN OUTPOURING OF COMPLAINTS FROM MY CONSTITUENTS. LITERALLY, I CAN GO NOWHERE IN CONNECTICUT WITHOUT BEING STOPPED BY A CONSTITUENT TELLING ME HOW HE OR SHE HAS BEEN BORROWING FOR YEARS BUT NOW CAN NO LONGER GET CREDIT.

I HAVE HEARD STORIES OF THE INABILITY TO GET CREDIT FROM REAL ESTATE DEVELOPERS WHO HAVE BEEN IN BUSINESS FOR 40 YEARS, HAVE NEVER MISSED A PAYMENT, AND HAVE PROJECTS THAT ARE FULLY PRELEASED. I HAVE HEARD STORIES FROM BANKERS ABOUT REGULATORS ARBITRARILY FORCING WRITEDOWNS BEYOND WHAT THE BANK THINKS IS REASONABLE. BUT MOST OF ALL, I HAVE HEARD COUNTLESS STORIES FROM SMALL BUSINESS PEOPLE WHO HAVE IMPECCABLE CREDIT RECORDS AND EITHER CANNOT GET CREDIT OR ARE HAVING THEIR LINES OF CREDIT PULLED.

HOW MANY TRULY CREDITWORTHY BORROWERS CANNOT GET CREDIT OR CANNOT GET AFFORDABLE CREDIT ? I DO NOT KNOW THE ANSWER, BUT IT IS CLEAR THAT A PSYCHOLOGY HAS DEVELOPED THAT IT IS HARDER TO GET. THUS, A CONNECTICUT BUSINESS AND INDUSTRY ASSOCIATION SURVEY FOUND THAT ALTHOUGH ONLY 24% OF THE PEOPLE SURVEYED HAVE ACTUALLY BEEN DENIED CREDIT OVER THE PAST 6 MONTHS, FULLY 65% THINK IT WILL BE MORE DIFFICULT TO OBTAIN CREDIT OVER THE NEXT YEAR AND 83% THINK THERE IS A CREDIT AVAILABILITY PROBLEM.

UNQUESTIONABLY THE CONNECTICUT ECONOMY HAS SLOWED DOWN, ALTHOUGH I THINK IT'S IMPORTANT TO POINT OUT THAT THE ECONOMIC INDICATORS REMAIN GOOD, WITH LOW UNEMPLOYMENT AND THE HIGHEST PER CAPITA PERSONAL INCOME IN THE COUNTRY. DID THE REGULATORS CAUSE THE SLOWDOWN ? NO. HAVE THEY EXACERBATED A CYCLICAL SLOWDOWN, JUST AS PROGRAM TRADING EXACERBATED THE STOCK MARKET DECLINE OF 1987 ? I THINK THE ANSWER TO THAT QUESTION IS FAR FROM CLEAR AND THAT IS ONE OF THE QUESTIONS I INTEND TO PURSUE AT TODAY'S HEARING.

I HAVE CONDUCTED SEVERAL MEETINGS WITH BUSINESSMEN, BANKERS AND REGULATORS OVER THE LAST 4 MONTHS TO TRY TO GET TO THE BOTTOM OF THIS MATTER. COMPTROLLER CLARKE HAS BEEN CONSISTENTLY COOPERATIVE, INCLUDING WALKING INTO THE LION'S DEN IN CONNECTICUT JUST THIS LAST MONDAY TO FACE A LARGE GROUP OF ANGRY AND FRUSTRATED BORROWERS AND BANKERS. HE IS SAYING THE RIGHT THINGS--THAT BANKERS NEED TO BE MORE CAUTIOUS DURING AN ECONOMIC SLOWDOWN BUT SHOULD CONTINUE TO MAKE LOANS TO CREDITWORTHY BORROWERS. THERE REMAIN, HOWEVER, QUESTIONS AS TO WHETHER BANKERS AND HIS OWN EXAMINERS ARE HEARING THESE WORDS AND TAKING THEM TO HEART. JUST AS I THINK THE CONNECTICUT MEETING HELPED DRIVE THESE POINTS HOME, I HOPE THIS HEARING WILL DO THE SAME THING.

The **Chairman**. Very good, Senator Dodd. Senator Garn.

Senator **Garn**. Thank you, Mr. Chairman. Let me address an area of this so-called credit crunch that we have not talked about yet. Chairman Seidman mentioned it—Mr. Fritts reading Chairman Seidman's testimony—mentioned that bankers do have concerns about environmental lender liability, and this is affecting lending decisions, and I will give you one anecdotal story, a situation where what had formerly been a very profitable automobile agency, a Toyota agency, and went into bankruptcy. A local bank in my State got it all back, and had numerous bidders to take that over, and they found out there were some environmental problems with the building and the ground surrounding it from oil and fuel leakage and so on, so what they ended up doing was they sold the inventory, and they sold the franchise. The bank has the building. And what to do with it, I don't know. The new agency has moved someplace else. It is cheaper to build a new building. Start from scratch, than try to repair the environmental damage.

Now, there are a number of stories like this that I have heard where an innocent lender goes in, had nothing to do with the environmental damage whatsoever, and yet is being held accountable, and this also, I understand, is having some impact on the insurance funds.

That is why I introduced a bill that Mr. Fritts mentioned, to limit the liability, super fund liability of innocent lenders when they acquire property through foreclosure.

Well, my question is simply, Mr. Fritts, how much of a problem do you think this is causing, and how important do you think that it is, not only for the insurance agencies, but for banks as well, that we do something about limiting this liability for innocent lenders that had nothing whatsoever to do with it?

I happen to think this is part of any so-called credit crunch that exists. That bankers are simply going to be very, very wary about making loans if they think they are going to be left holding the bag for a bankrupt business who created environmental problems?

Mr. **Fritts**. Well, I agree with you, Senator Garn. In fact, I think maybe the superfund liability may be a good comparison with an iceberg. You can see it out there, but the true extent of the dimension of the risk is well underneath the surface, and we don't really know where this is all going, but we do know this, that every lender and every acquirer of a piece of real estate, and RTC certainly has a lot, the FDIC has a lot over on its side, any time that you add a dimension of uncertainty and a dimension of possible liability, it is going to make, number one, the acquirer less likely to acquire, and it is going to make the lender less likely to lend.

And to the extent that they have those uncertainties, it is going to drive that price down.

So, we think your legislation—proposed legislation—is right on point, and we would encourage Congress to pass the legislation.

Senator **Garn**. Well, beyond the issue, again, of the liability of innocent lenders, I don't think that anybody intended when we passed FIRREA and the tremendous amount of money that we are looking at there, that this was intended to be used as superfund clean-up.

Now, my point is, I certainly want these sites cleaned up. And we appropriate money in the Appropriations Committee for superfund for that purpose, but with the enormous liability that the taxpayers have out there, to go through the back door to clean these up by using FIRREA funds, or RTC funds, doesn't make any sense to this Senator at all.

If we are going to have to clean those up, it seems to me it should go back and be straightforward, up on top of the table, and taken out of superfund funds to do that, or to do everything that we can to go back and get the polluter who caused that. That ought to be the first recourse. They ought to be the ones that pay for it. But as much difficulty as we have, this is something that has not been well addressed, and I think it is a big and growing problem with the example that I used.

There is no reason why that bank should get stuck with a bad loan and a building that they had nothing to do with. The new purchaser is able to go out and say, "Hey, I will build a brand new building and start from scratch," and the original owner gets off the hook, and the bank gets left holding the bag.

I don't have any accurate figures. I would appreciate it if you could supply the committee, as we get more into this, how big that iceberg is, what the potential cost is, not only the individual banks, but how it would impact our resolution of these properties and minimize the loss to the taxpayer. I don't think that any of us intended that this was an environmental bill when we passed it last summer, as big and important as those problems are.

So, any information any of you can supply the committee in that area, I would appreciate it, because I think it is a problem that has been generally overlooked and certainly I could not criticize a bank for being very, very careful about loans that they are making if they have any suspicion whatsoever that they would end up in this sort of a situation of paying vast amounts of money for environmental clean-up, in many cases much more costly than the value of the asset that they have taken over as a result of bankruptcies and foreclosures.

Thank you, Mr. Chairman, my time is up on this round.

The CHAIRMAN. Thank you, Senator Garn. Senator Kerry.

Senator KERRY. Thank you. I have quite a few questions. I am not going to be able to get through in one round, but I would like to start, I guess.

Mr. Clarke, first of all, let me say that I join Senator Dodd in applauding the way in which I think you have tried to be open and accessible and to help explain what is going on.

I think, perhaps, as much as anything that we need, clarification, explanation, is necessary now and I think the lines of communication are very, very important here. And I say that very mindful of the difficulty.

I was looking for and editorial here that recently wrote about the nerves of steel are necessary in regulation right now, and the difficulty, obviously, between shutting down the system on the one hand, and the balancing on the other side of regulating, so you avoid an S&L crisis. And I think every one of us here is sensitive to that, mindful of the difficulty, but we have obviously got to not be intimidated in our role because of that. To not ask the probing questions that try somehow to make clear to our folks what the standards are, and I think as Senator Sarbanes said, there is not a clarity still as to what the standards are, and we are still hearing differing reports.

You on the one hand say the rules haven't changed, the economic climate has changed. But we hear from bankers that, indeed, the rules may have changed. That certain things are being applied differently and that some standards are different.

Now, I would like to just probe that a little bit if I can in this first round. Have you always used the model that you described, the computer model which identifies which banks have high exposure to real estate loans. Is that a model that has been there consistently, or is that a new model?

Mr. CLARKE. The model itself, Senator, is a new product. But all it does is replace a yellow legal pad, a pencil and a bunch of economic data that examiners would otherwise use to rank the banks in terms of their exposure to real estate. It helps examiners determine which banks have the largest exposure in markets that have been identified through external economic data as soft. There is nothing really magical to it. It is simply an efficiency device to help us allocate our resources, to determine in what priority we use them.

Senator KERRY. Have the assumptions which you plug into that model, assumptions about the rate in which a region will grow, what the interest rates will be, or growth rates and so forth, or new construction, or leasing or absorption, all of those variables, have those changed in that computer model with respect to New England, Massachusetts?

Mr. CLARKE. Those assumptions, Senator, are supposed to be reflective of the reality in that particular marketplace. In other words, had we had the model 2 years ago, which we didn't, we would have plugged in different absorption rates, different lease and rental rates and so on, than we would plug in today. That is simply a reflection of the economic market itself. And you can also manipulate the data any way you want to, obviously. You can assume anything.

Senator KERRY. That is the key point. That is exactly the key point. Now, that requires judgment, and there is a lot of discretion in it, isn't there? Is there—I know you probably don't have this data here with you today, but I think it would be interesting for us to be able to take a look at, and I wonder if you could supply the committee within a short span of time the assumptions which were used by the examiners in their recent review in Boston? Those basic, across the board economic assumptions?

Mr. CLARKE. I need to apologize. As Senator Sarbanes said, I obviously haven't communicated clearly in explaining what our model does. The assumptions that we use in that model to decide which banks might be, and I underscore might be, impacted the worst by a real estate downturn in a particular market have absolutely nothing to do with what we do when we actually look at the individual loans. That is what I was saying in my opening statement. We look at the individual loans separately.

Senator KERRY. Do you apply different standards when you look at the individual loan? I would assume the same interest rate standards, growth standards, et cetera would——

Mr. CLARKE. Maybe we need to discontinue using the model because there seems to be so much confusion about it. The purpose of the model is simply to identify the banks that have the largest exposure to real estate in a market that has previously been identified through external economic data as being a soft one. We can do that without the model, and did do it without the model before we had the model. Once you have picked out those banks, you actually go into the banks and look at individual loans.

Senator KERRY. When one of your examiners would sit and evaluate an individual loan, did you provide that individual examiner with a set of your guidelines or assumptions, or perception of the realities of the region by which they should make a judgment on that loan?

Mr. CLARKE. No. The examiner is supposed to make the judgments about that loan based on information that the examiner is supposed to determine about the market from having examined banks in the market, and from talking to the banker whose bank is being examined.

Senator KERRY. I see. Do you see the problem here? My light is already on, and we are just getting at it, but now you say the rules haven't changed, is that correct?

Mr. CLARKE. The basic rules that relate to real estate transactions have not changed.

Senator KERRY. And the application of them hasn't changed?

Mr. CLARKE. Let me give you an example of where I think there is confusion on this. I mentioned guarantors in my opening statement. If you looked at a construction loan that had a personal guarantee on it 2 or 3 years ago when real estate values were still going up, when rental rates were on the up trend rather than the down trend, when the project that was securing the loan was producing enough cash flow to more than service the debt, we probably would not have looked as closely at the financial condition of the guarantor. We would have expected the bank to have information about the financial condition, but the guarantor was much less relevant to the loan.

When we look at that loan today, when the project may not be producing enough cash flow to service the debt and the value of the project is less than the principal amount of the debt, that guarantor has become very important. We would look very carefully at that guarantor, and we would want to look behind the basic balance sheet of the guarantor to see what the cash flow of the guarantor was.

If a banker believes that we are looking more carefully at the condition of guarantors than we did 2 or 3 years ago, that is a correct observation. But it is not because our standard in requiring banks to have guarantors' financial statements has changed. It is just it wasn't as necessary to pay as close attention to those guarantors previously.

Senator KERRY. Then how do you account—the red light is on. I just want to ask a last question, and then I will come back. Then how would you account for the kind of situation—this is true to life—where there is an individual who is involved in an oil company. Been involved for 20 years. Denied credit in Boston with one bank with whom he had done business for 20 years, goes to New York, gets financing for the exact same deal, exact same perceptions, in 1 day, and as a consequent of the treatment by the bank in New York, pulls out his accounts and is now banking in New York rather than Boston. Isn't that——

Mr. CLARKE. Two observations about that. First of all, I can't tell you without knowing more facts about why the banker——

Senator KERRY. Doesn't that suggest there is a different standard being applied?

Mr. CLARKE. No. It may suggest that the bankers are applying different standards, but it doesn't suggest that the regulator is necessarily applying different standards. That is what I mean; I don't know what went through the mind of the banker in Boston who decided not to grant the loan.

Senator KERRY. I want to come back to that, because it is very important to the psychology of what is happening.

Mr. CLARKE. But I do think it is an example of the market working. If that happens on a repeated basis, which I suspect it will, where credit worthy borrowers are able to get credit somewhere else, pretty soon the bankers who are turning down those good credits are going to find that their market share has dropped and their profitability has dropped, and they wished they had some of those customers back.

Senator KERRY. They may not be able to, though, if the result is that the rest of the economy, because of the tail off in light manufacturing cuts in defense spending, gross over-supply in real estate, and reduction in the computer industry and high technology leave you with no commercial liability, and that is where I want to come back.

The CHAIRMAN. Very good. Senator Heinz.

Senator HEINZ. Thank you, Mr. Chairman. Although I am not from New England, I do want to for a moment pursue an aspect of that question because, Mr. Fritts, in your testimony on behalf of Mr. Seidman, you state that the banks in New England are tightening credit standards in part due to the overhang of properties held by the Resolution Trust Corporation. Although we all know the RTC is the Nation's largest landlord—they didn't plan it that way, that is the way it worked out—is experiencing its own form of a credit crunch.

What is the impact of the real estate overhang on the soft real estate markets? And the question I have is: Has anybody, the Resolution Trust Corporation, the OTS, the Comptroller, done an analysis of this overhang on these markets?

Mr. Clarke, let me start with you. You probably have the largest number of people.

Mr. CLARKE. We are not involved with the RTC's ownership of properties, although I do serve on that Board. We have used the existence of large amounts of RTC property as one of the factors that we would plug into this model that we use, in other words, to suggest that you might have—and, again, I underscore "might"—have more of an impact on a market where you have a lot of RTC property than one where you have just a little bit. Of course, most of that property is in the Southwest.

Senator HEINZ. Now, is the model sensitive to whether or not the RTC sells or dumps into a soft market even more properties, and what that does to property values?

Mr. CLARKE. The market simply says, and the model simply says, Senator, that if you had a large quantity of RTC property in a particular market it might be more likely that real estate values in that market would drop 5 percent or 10 percent, or just an arbitrarily assumed number.

Senator HEINZ. Here is what I am worried about. I am worried about the taxpayer. And it seems to me that nobody is looking at the following big picture. Maybe I am wrong, I hope I am wrong, but from what I hear you saying is this: The RTC is doing its own thing. They, from the conversations I have had with them, or have been told, don't worry about anything, just unload that property as fast as you can. The longer you hold it, the more it costs. You don't know how to manage most of it. Get rid of it. If that is true, and for the most part I believe it to be true, they can have an impact on real estate values in markets.

Your examiners come in with your new, or revised, or improved, or whatever you want to call it—it is a new model—suddenly collateral values look a lot less good. There are write downs. There are refusals to extend credit. Banks that weren't in trouble become troubled, and what you have is more bank failures, or S&L failures as the case may be, because of the dumping problem.

We run into the same problem, by the way, in lots of other areas of economic competition when foreign countries subsidize their steel industries. I have a little experience with this in Pittsburgh, and dump steel. It comes into the United States. It has the effect of causing steel companies to go out of business, and steel plants to close. That is not unexpected.

Why doesn't dumping by the RTC, whether it is from their point of view justified or not, have a similar effect on creating other problems that go either to the FDIC or to one of our other insurance funds.

Mr. CLARKE. It could if you had dumping. Let me just make two observations about that. First of all, the effect of the RTC on a particular market is going to take place irrespective of our model. Our model has absolutely nothing to do with that, nor does our model have anything to do with what the examiner does once he gets in the bank.

Senator HEINZ. I wasn't asking about your model. I was making the following point. There doesn't seem to be anybody who is saying: What is the least cost solution to the taxpayer? Should we keep these properties off the market? We will lose some money by keeping these properties off the market a little longer, and the RTC, but if we sell them now we are going to cause several other financial institutions to go—or other people to go into bankruptcy, and that is going to have a cost which we are not recognizing over here at the RTC, and I worry that nobody is making the trade-off, is looking at the big picture.

Maybe Chairman Greenspan has an answer, however.

Mr. **Clarke**. Let me just make one other point, and then Chairman Greenspan can probably answer this better than I.

The RTC Board has taken a look at this issue, and, in an effort to strike what we hope will be the right kind of balance, we have authorized property managers to drop the price of a piece of property after it has been actively marketed for 6 months, to 85 percent of its appraised value. A manager can drop it another 5 percent, to 80 percent of its appraised value, after it has been actively marketed for another 90 days. It can't be dropped below that without getting another appraisal. The idea is to expose the property to the market. If the appraisal that was originally prepared was too low, then probably the market will respond and that property will get sold. If the appraisal was too high, then the market will respond and it won't get sold, and 9 months later it will have to be reappraised.

Senator **Heinz**. I don't want to take all my time on this question, but I guess—you get to the end of the two 90 day, or 120 day periods. It hasn't sold. The easiest thing in the world is to get a new appraisal. It is going to be at a minimum 85 or 80 percent of what it was before because you proved it. You proved that its market value wasn't 85 percent of a 100 percent by not being able to sell it.

So, the process continues, and you run it all over again. Mr. Chairman, if I might continue.

The **Chairman**. Can we get to Chairman Greenspan's comment?

Mr. **Greenspan**. Let me just make a very quick comment, because I think it is important that we don't allow the question to stay unanswered as though we at the Oversight Board, or they at the RTC Board are not confronting this question, because Senator, that is the crucial strategy question of all of the real estate sales activity of these organizations.

In other words, we know, on the one hand, that we have this very large block of real estate overhanging the market. The people in the market know it is there. It clearly has an effect on current prices. The issue is not clear as to whether or not the price damping in effect is greater if you do nothing, or if you sell it, in many instances.

I think the problem of developing strategies in particular geographic areas fundamentally gets to this question of "is it a more appropriate strategy to accelerate sales or to lag them?" and I don't think one can make a generic statement very easily that encompasses every single area of this country.

I think it is a localized question, but I would say we spend more time on that as a fundamental question than most any other issue that we confront.

Senator **Heinz**. Have you come to any conclusions?

Mr. **Greenspan**. Yes. It is a little of both. First of all, it is too early to come to really significant conclusions because we haven't tested the markets yet. But what evidence we do see, does suggest that the overhang is an unquestionably serious problem, deflating the values of real estate properties. The mere fact that we—the RTC and Oversight Board as a group—are holding onto these properties, and the markets know that we are required by law to sell them, has a depressing effect. In certain instances, the sooner we get that stuff out of the way, the better. My overall impression is that, other things equal, it is better to sell that type of property sooner rather than later. But there are regional differences and one has to take those into consideration.

Senator **Heinz**. Did we make a mistake in mandating this rapid sale?

Mr. **Greenspan**. I don't think so, Senator. I think that in the context of that mandate, it is nonetheless our obligation to look at local markets and make certain that we do not unduly depress them. That is an obligation that we have got as well.

Senator **Heinz**. Mr. Chairman, my time has expired. I just want to make an observation that I made earlier. If it stirs people up, so be it.

I remember how cautious and forbearing everybody was on less developed country debt, running from 1981 to the present, and the idea at the Fed under Alan Greenspan's predecessor, Paul Volker and others, was that you have to give the banks time to work out of this problem, and absorb these losses over an extended period of time, and slowly some banks are, and some banks aren't, and there is concern that if you force certain banks to do it, their capital will be in trouble, and I can't help observing that if LDC had stood for land development and construction, rather than less developed country, we might not have all these problems that we think we have around the country.

The **Chairman**. Senator Dodd?

Senator **Dodd**. Thank you, Mr. Chairman. Chairman Greenspan, I wonder if you might comment on a couple of observations. One has to do with the new capital standards as having an impact, and we come back to the credit crunch issue here if I can.

Under those new standards, you don't permit loan loss reserves to be counted as part of tier 1 capital, and so when banks have to increase these reserves, as has happened in Connecticut and elsewhere in New England, obviously it reduces both income and capital, and thereby reduces the capacity of the institution to lend.

I wonder if you might comment on those. I understand the anti-recessionary rationale of it was involved in a bit of that but, nonetheless, I wonder if you might comment on whether or not you believe that is a contributing factor and if so, what might be done to——

Mr. **Greenspan**. I would certainly say, Senator, were it large enough, the answer is yes, because if you take it at the extreme, obviously to the extent that an individual commercial bank decides that it wishes to increase its capital, one of the things that it is likely to do is to bring its assets down, or at least slow the rate of growth in assets, because what we are looking at is a ratio of capital to assets, or some variation of that.

A typical way of meeting capital standards, other than going out and raising capital or curtailing dividends, is basically to curtail the growth in assets, to the extent that this is done that, there is a tendency for the availability of credit in the markets to decline, and there would, under those conditions if it were large enough, be some upward pressure on bank lending rates. Obviously if you as a bank are going to contract a little bit, you are going to be far more selective, and the net effect is going to be to improve, at least as you see it as a commercial banker, the quality of the asset structure that you have, and that will tend to edge rates higher.

Having said that, Senator, I don't think that we see anything of sufficient substance which raises that as a caution flag. There is no question in my mind that we have to get commercial bank capital higher, and that is a process which has been going on now since the early 1980's with some considerable progress.

I might just say parenthetically as a response to what Senator Heinz was referring, that it wasn't LDC debt that was the crucial issue, it was the extraordinary size of the big potential debt problem, and the forbearance was essentially an endeavor to enable commercial banks to work their capital-asset ratios up, and in the vast majority of those instances, they have, in fact, succeeded in doing that.

Now, there are a lot of other implications with respect to future lending and the like, but I don't believe it was just the LDC debt, it was essentially a number of other problems, but fundamentally the very serious threat which liquidating that whole situation at that time would have had for the commercial banking system. I would say in retrospect that those actions, in my judgment, were correct, but I do recognize that the issue of raising capital per se has certain downsides, and one of the downsides is what you point out, Senator. I think we have to be very careful in applying these standards not to follow in a blind way without awareness that there are potential consequences. I think we would be obligated when we see the very difficult issues to bring them before the Congress in the event that legislation is required or some action other than what we have been doing is mandated.

Senator DODD. I appreciate your comment on that, Mr. Chairman. Let me—I want to come back to that point in a second.

But, I didn't want to miss the opportunity. Congressman Schumer and I are about to introduce a full interstate banking legislation. And, we've got a crowded agenda here, but I wonder if you might comment on the wisdom of that particular approach as it effects this particular question, the idea of making it possible for lending institutions outside of a region that their reacting was a positive way of——

Mr. GREENSPAN. Is this repealing the McFadden Act?

Senator DODD. Yes.

Mr. GREENSPAN. It's unquestionably a highly desirable thing to do for the reason you suggest, Senator, and for a number of others.

Senator DODD. I appreciate your comment on that. I would like to come back to your conclusion on the first point dealing with the capital standards issue.

And, Mr. Chairman, I would ask unanimous consent that a survey of 1,400 businesses and industries in Connecticut be included in the record at this point.

The CHAIRMAN. Without objection.

[The survey referred to follows:]

CBIA

Connecticut **Business&Industry** *Association*

John R. Rathgeber
Executive Vice President,
Secretary and General Counsel

May 18, 1990

Honorable Christopher Dodd
United State Senator
444 Russell Office Building
Washington, D.C. 20510

Dear Senator Dodd:

During the first two weeks of May, CBIA conducted a survey of its membership to determine the availability of credit in Connecticut. Our objective was to gauge the magnitude of the well-publicized "credit crunch" and to provide a statistical base for determining how businesses are responding to this issue.

Nearly 1400 companies of all sizes, types and geographic locations responded to the survey. Their responses clearly point to several conclusion. First, there is an overwhelming perception that credit has become less available and that this is causing companies to reduce future investment in Connecticut. Second, the problem of credit availability is cutting across all types and sizes of business.

I have enclosed a copy of our survey results. If you have any questions or would like any additional information, please feel free to contact either myself or Rick Mattoon at CBIA.

These results point out that credit availability is a significant problem for state businesses and if ignored will impact future economic growth in Connecticut.

Sincerely,

John R. Rathgeber

JRR:clr

Number of Responses = 1093

[illegible] Credit Availability Survey

Please answer the following questions and return the finished survey in the envelope provided by Friday, May 11th.

1. Have you tried to obtain some form of financing in the last six months?

69.5 yes 29.8 no

1.1 If yes, how difficult was it to obtain financing compared to one year ago?

[illegible] more difficult
21.6 no difference
2.0 easier

1.2 If no, how difficult do you think it would be to obtain financing for your company when compared to one year ago?

65.7 more difficult
31.7 no difference
2.5 easier

2. Do you think there is a credit availability problem in Connecticut?

82.5 yes 11.9 no

3. Do you think there is a credit availability problem for your industry?

68.1 yes 24.3 no

3.1 If yes, how much is the lack of available credit hurting your industry?

[illegible] a great deal
25.7 some
7.1 a little
4.0 not at all

4. How have your financing needs changed from one year ago?

33.7 looking for more financing
45.8 looking for the same level of financing
15.1 looking for less financing

5. Has the type of financing you are looking for changed in the last year?

30.8 yes 63.6 no

5.1 If yes, what type of financing are you most in need of?

35.5 working capital (bridge loans, inventory, etc.)
11.4 capital for machinery and equipment purchases
5.2 capital for expansion of existing plant or office space
7.9 capital for new development

6. Do you think that it is easier, harder or about the same, in terms of ability of your company to obtain the following types of capital compared to one year ago?

a. working capital

2.9 easier
63.1 harder
23.3 same

b. capital for machinery and equipment

2.4 easier
44.0 harder
29.4 same

c. capital for plant and office expansion

1.2 easier
50.7 harder
21.4 same

d. capital for new development

1.5 easier
59.1 harder
15.3 same

7. Have you been turned down for a loan during the last six months?

23.9 yes 70.2 no

7.1 If yes, how serious was the impact of being turned down on your business?

37.8 significant hardship
37.8 some hardship
18.9 some inconvenience
5.4 not a problem

8. Have the terms of any loan you have received in the last six months become any more restrictive?

35.0 yes 27.4 no 27.7 n/a

9. Have the fees for any loan you have received in the last six months been increased?

24.7 yes 38.8 no 29.1 n/a

10. Have any of your current loans recently been reclassified by the lending institution?

16.7 yes 59.7 no 17.8 n/a

11. Has any of the collatoral used to secure any loan your business might have, been reappraised in the last six months?

22.4 yes 55.0 no 17.8 n/a

12. Have you had a business loan called by the lender in the last six months?

10.6 yes 74.3 no 10.9 n/a

13. Do you know any clients or other businesses which have recently been turned down for loans which they had expected to receive?

55.2 yes 38.9 no

14. Who has been your most recent lending source?

73.5 your regular commercial bank
7.9 your regular savings and loan
5.8 a new commercial bank
1.1 a new savings and loan
4.0 a non-bank commercial lender

15. Is the current availability of credit influencing your plans for investment in Connecticut?

[illegible].0 significantly reducing future investment
[illegible]9.6 reducing future investment
32.0 not affecting future investment
0.2 increasing future investment

16. Do you think that the availability of credit is negatively impacting the Connecticut economy?

86.3 yes 7.8 no

Please answer the following question for classification purposes.

Type of Business:

35.9	manufacturer
7.9	finance, insurance, real estate
14.2	consumer & professional services
12.7	construction/development
9.8	wholesale trade
8.6	retail trade
9.2	other

Number of Employees:

2.0	over 500
2.7	250-499
8.4	100-249
11.0	50-99
20.5	25-49
53.3	under 25

Location by County:

37.8	Hartford
15.9	Fairfield
6.0	Middlesex
22.1	New Haven
8.2	Litchfield
2.9	Windham
4.3	New London
1.5	Tolland

Senator Dodd. This was conducted by the Connecticut Business and Industry Association in the State, a very broad cross-section. In fact, the data here will indicate how broad it is when it gets into manufacturing, real estate and the like.

But, I would say to you, Mr. Chairman, and I would be glad to have anyone else comment on this if they would like to—and I will supply a copy of this for you, but I think it makes the point that you were making, in a sense there is a problem here. And, it's being reflected by the response of business people to these questionnaires.

How difficult was it to obtain financing compared to 1 year ago? In excess of 76 percent of the 1,400 businesses respond that it's much more difficult in Connecticut.

Do you think there is a credit availability problem in Connecticut? Eighty-two point five percent respond that there is.

Do you think there is a credit availability problem for your industry? Sixty-eight percent respond affirmatively.

In terms of types of capital in every area—working capital, capital for machinery, capital for plant and office expansion, capital for new development, in every single one of those categories in excess of 50 percent say it is much harder to acquire that capital.

If yes, how serious was the impact of being turned down on your business? Seventy-five percent of the 1,400 respondents indicate that it had a serious impact on their business.

Was the current availability of credit influencing your plans and investment? Sixty percent say it is significantly affecting their investment plans.

Do you think that availability of credit is negatively impacting the economy? Eighty-six percent respond yes.

I will give you this surely. But, I think it, in a sense, suggests that that is what is happening, that with these standards placing additional capital in the loan loss reserves and creating that kind of crunch we are seeing.

I mean, these are people who are not alarmists. This is not a crowd that is self-serving to be saying these things. These are business people who are normally a pretty optimistic crowd even when maybe they shouldn't be as individuals.

And, so when you get this kind of a reaction where the numbers are overwhelming in a very broad survey of businesses, retailers and so forth, that's the reason there is such concern here; that, in effect, we may be seeing that impact.

I don't know if you want to comment on that.

Mr. Greenspan. Yes, if I may, Senator. And, I would surely be curious to hear my colleagues' view on this.

I think what we are seeing is a very difficult problem where we are going from standards in the commercial banking industry which were clearly more lax than they should be, and we have as evidence of that that nonperforming loan ratios have been rising.

I think there is no question that all bankers would like to come back from that position to what they would consider to be sound and normal. Some, I think, have gone too far, as I indicated in my prepared remarks.

But, the process of going from here to there feels very restrictive. And, I think we see that, not only in Connecticut, not only in New

England, but I think we see it in many other areas in the country in which the mere coming off some of the lax standards gives the impression of abnormal tightening.

We have to try to differentiate whether the issue is a restoration of sensible balance or overdoing it. And, I think it's quite possible to overdo it.

As I indicated in my opening remarks, I think there is an inevitability when one overdoes it in one direction to tend to overdo if in the other direction. And, unless we would repeal the law of human nature, you have to be very careful that that doesn't happen.

Nonetheless——

Senator DODD. It would seem it is, though. That's——

Mr. GREENSPAN. Well, I'm not sure. I'm not sure, because, in effect, it could be that a substantial part of the response that you are getting is the result of coming from overly lax credit standards to something which is more normal. To the average borrower, it feels as though credit is being tightened, but, I'm not sure we can determine from that type of survey if it really is.

And, that's the reason why it is such a difficult problem and why I think we get, as Senator Kerry has pointed out, seemingly extraordinary differences among bankers, regulators and borrowers as to what the nature of this thing is. I think everybody would like to remove the laxity.

Senator DODD. No question.

Mr. GREENSPAN. And, nobody wants to go on the other side. But, we have very great difficulty in knowing where that line is.

Senator DODD. I appreciate that.

The CHAIRMAN. Thank you, Senator Dodd. I want to say one more thing. We will do one more round of questions.

I have told Chairman Greenspan, we will excuse him at 12:50, because he must leave to be present at the swearing in of David Mullins as a new Federal Reserve Board member. So, we will make that accommodation.

I want to ask two more things. Then we will go to my colleagues here.

Chairman Greenspan, let me ask you this: In your answer to Senator Heinz's question whether you should push properties out the door or hold them, you said that you have to evaluate them region by region and area by area.

The key centerpiece of the question is: Is the real estate overhang at the RTC, growing each day, clustered in some areas of the country, is the sheer volume of that real estate overhang sufficient, in the current economic conditions, to create a problem? It may drive property values down further whichever way you do it—whether you sell it at fire sale prices or whether you hold it off the market when everyone knows that there is a fire sale coming.

I wonder whether the sheer volume of that real estate is creating a pressure on balance sheets of banks and savings and loans. In either case it will cause a downward revision because asset values are dropping.

I am concerned that this is a material factor that could have secondary effects which no one wants, or intends. It is just part of the the dilemma we are in.

Is that right?

Mr. GREENSPAN. I would say yes, in part. The part in which I say it may not be is that the mere moving of the property from a failed thrift to the RTC I don't think makes all that much difference.

The CHAIRMAN. No. I'm talking about the next transaction.

Mr. GREENSPAN. What I'm trying to say is that I suspect that the mere knowledge of the fact that there is a property out there that must be sold at some point has already depressed the contiguous market prices.

The unresolved issue is whether or not the adjustment is fully made at that stage, so that when the actual transaction is made it will not actually move the price level lower. You can at least make the theoretical case—and I'm not sure that I feel comfortable making it—that the mere existence of the property which is known to be available for sale has already moved the price levels down as far as they will go.

I'm not sure that's the case. That's the reason why I say yes, in part.

I do think it is probably also incorrect to assume that there is no effect on the overall contiguous real estate area prices prior to the sale; and that, therefore, only when the property is sold is there really a price effect. That I am sure is false.

But, it's somewhere in between.

The CHAIRMAN. Let me ask a related question. Mr. Clarke or Mr. Ryan or Mr. Fritts have to make other evaluations. There has to be a downward pressure on real estate prices generally, particularly in areas where you have greatest volume of assets taken back. There has to be a downward reevaluation of assets held by the banks and savings and loans that are still operating.

I assume that is what happened at the Bank of New England. I don't know how the Bank of New England one day passes muster and the next day it is several tens or hundreds of millions of dollars in the red.

I assume it is partly a downward valuation of assets.

How much of that ripple effect is still yet to come through to other banks and other savings and loans.

Mr. GREENSPAN. I think there is probably some of that. What the order of magnitude is, I find no way of making a determination of, but there is some.

The CHAIRMAN. Well, let me ask you fellows: How much anxiety and heartburn does this secondary effect give you?

Mr. CLARKE. Any time, Mr. Chairman, that you are in an environment where there is the possibility of some slippage of real estate values and you have institutions that you are supervising that have large exposure to real estate, you have to be concerned about it. And, we are concerned about it. We are watching it very carefully. But for all the reasons that Chairman Greenspan has given—and I don't disagree with a thing that he said—you simply can't predict all of this with precision.

The CHAIRMAN. But, you are requiring banks to set aside larger loan loss reserves in part because of this problem, are you not?

Mr. CLARKE. No. We are requiring the banks to set aside reserves because of what is present in the marketplace today. The question

I think you are asking is what may be present in the marketplace 6 months from now.

The CHAIRMAN. Well, I am asking both. I think part of what we are seeing today has been 6 months in the making. I am also trying to look ahead at what events today may lead to over the next 6 or 12 months.

I think you have both problems. Some of the downward valuations that you are seeing right now are part of a chain of events that has been in motion for some time I expect also that we will see more in the future.

Mr. CLARKE. You are exactly right. There has been a softening in these values that has been taking place over a period of time, although it has been more severe within more recent periods.

The CHAIRMAN. Well——

Mr. CLARKE. The really important question is what is going to happen going forward. You have different attributes in different economies, obviously. You have different supply in relation to demand ratios. To the extent that you have economies, which we still do, fortunately, where there is a net increase in the demand for housing, for shopping centers, for commercial office space, then there is absorption going on that is helping use up the surplus. In other environments, the Southwest being a classic example, you had a demand curve that was going down, which was making the problem worse. You had an oversupply and then you had demand that was going down rather than up.

The CHAIRMAN. That is why we have all, not just one, of you here today. Mr. Fritts said today that this real estate problem has spread to several other States in a very short space of time. And, he said frankly that he thought it would continue.

So, it sounds to me that this problem is growing dynamically. You are going to have to have other write-downs and more loan loss reserves, because this problem is spreading.

It's not a stable problem or a receding problem. It's a growing problem.

As the person responsible for the solvency of the insurance fund, Mr. Fritts obviously has a proper concern about the problem.

Do you disagree with that?

Mr. CLARKE. The only difference that I would have is that I don't think this is a disease that is spreading throughout the country. I think that there are other markets where some of the early signs of softening are also present and where some softening has occurred. And, there may very well be some losses that have to be taken or some reserves that have to be built against potential losses in those markets.

The CHAIRMAN. Let me ask you, for the record, about the meeting that you had with the large bank group a couple of months ago. It has been well publicized. From the notes or the talking points you used in your presentation please give us, for the record, a summary of what you said.

I do not need word for word, but the essence of your message. I would like you to provide that to us for the record. Will you do that?

Mr. CLARKE. Is this the meeting that Chairman Greenspan and Chairman Seidman and I had with the ABA board of directors?

The **Chairman**. Yes.

Mr. **Clarke**. That was not a meeting with large banks. That was a meeting with the board of directors of the ABA who represented a cross-section of community banks, large banks, and medium-sized banks.

The **Chairman**. Well, with that adjustment to the description of the meeting, please give us a playback, of what you said.

We need to know what concerns were expressed and how they were expressed.

Chairman Greenspan, I would like to ask you to do that also.

Can we expect that you will? (See p. 229.)

Mr. **Clarke**. I will be pleased to do it. (See p. 239.)

The **Chairman**. Very good. Senator Kerry?

Senator **Kerry**. Mr. Chairman, thank you very much. I would just like to beg your indulgence that hopefully this wouldn't be as short a round or not the last round, because there are a couple of areas that I do want to inquire about. But, I respect the chairman's need to move out of here.

Before I come back to the credit crunch issue, I really want to take advantage of the fact that we have OTC, the Oversight Board representatives, here and Mr. Fritts, Mr. Ryan and Mr. Greenspan, because I am deeply concerned about something. And, I want to bring this to your attention, not in any highhanded fashion but out of real fear for the groundwork that I think is being laid here which is very dangerous for all of us.

In Massachusetts, I really think it can be said—and I'm just going to tell it like it is—that those who govern have for a lot of different reasons—political and things that have nothing to do with this—lost the consent of the governed. And, it's a crisis.

I want to respectfully suggest to you that we are conceivably on the brink of having that happen as a result of this S&L/banking problem that we face in the country right now, nationally losing the consent of the governed, eliciting an anger that is without precedent in current or modern politics.

Now, let me just suggest to you that I wrote an article in the New York Times a few weeks go, "Where is the S&L Money," in which I suggested that it didn't all vanish in real estate deals. And, I talked about how the American people are going to be angry to learn that by simply wiring their money to another country bankers have been able to hide some of it, that they have been able to shelter it, that foreign governments through secrecy laws have been collaborations and so forth.

Well, today we pick up the New York Times, front page, "Fraud Uncovered in Property Sales in Savings Rescue." So, it's not enough that we had fraud in creating the initial problem and we still haven't done enough about that, but now we are hearing about the regulators are investigating a series of questionable practices—fees and salaries of hundreds of thousands of dollars paid to consultants and former savings executives, country club and other expenses billed to the Government, and even an attempt to pay for one property with a suitcase full of cash which may have been a money laundering effort by organized crime.

There is a high potential "for more scandal and rip-offs in the coming sales," said Charles Bowsher, the Comptroller General.

Then, you go into the article, the body of it, and it says first: "The regulators are still severely short staffed. The resolution trust has moved cautiously in hiring, filling about half its budgeted staff * * * " and so forth.

It goes on to say that another potential problem, the auditors say, is that while regulators do conduct background checks of the purchasers of savings and loans, the Government is not screening any of the buyers of the failed institutions' assets. Regulators expect that many of the buyers of the assets will be the property developers and speculators who defaulted on the loans from savings institutions for the same property.

In a way, the process is set up to encourage a holder of property whose value has plummeted in a depressed real estate market to default on the loan and then repurchase the property at a substantially lower price.

And, it talks about the potential for illegal activities in property sales that regulators say could well provide organized crime with a comparatively easy way to launder profits from illegal activities.

Now, I've got to tell you—and I don't want to prolong this or belabor it, but if that happens we are going to have a hell of a hard time telling the American people that we have been watching their tax dollars and that we are doing our job. And, when you look at the fact that we authorize and appropriated that $75 million and the administration came back with $50 million to do the job, even though Bill Sessions says he is understaffed, Dick Thornburg can't get to the countless referrals for fraud that have already been made, I'm just saying in plain and simple terms that if we don't treat this like the emergency that it is and get staffed and prevent these kinds of abuses, there isn't anybody who can go back to their electorate and suggest to them that they have kept the fox out of the chicken coop.

Now, I think it's very, very fundamental to our ability to be able to deal with a lot of problems we are going to face as we go down the road here. And, I implore you—you know, Tim, you and I talked about it in my office a couple of months ago, I implore you—and I'm going to write the President today and I'm going to continue to speak on the floor with Senator Heinz, Senator Wirth, Kerry and others in order to try to get people to listen on this, because I think the same consent problem that exists in a State like Massachusetts is going to exist nationally if this is allowed to fester.

Now, Mr. Chairman, let me just come back to the credit crunch issue in Massachusetts if I can for a moment. You, when you were here before, in answer to my question made what I thought was a very sound analogy. And, I appreciated it.

And, I was respectful of the fact that you don't normally comment on regions. And, I think it was important for us.

You said at that time that when you come off historic high rates of growth and you come down to historic moderate rates of growth, it feels like a recession, it has got all the psychological characteristics of something imploding.

And, then you noted that people project that process to continue straight down. "It doesn't always happen that way. In fact, most of the time it doesn't happen that way." That was your comment.

Now, you seem to be saying essentially that New England wasn't that bad, there was reason to have good hope. And, we are a strong economy, even today.

Senator Dodd has referred to it. I think we are an extraordinary economy in many respects—very, very diverse and strong.

But, in the past few months, almost all the data that I have seen indicates that nationally, not just in Massachusetts, the economy is grinding to a halt. Let me throw a few things at you.

GNP growth last quarter, .4 percent. Expected to be .9 percent in the first quarter of this year. Nonfarm payrolls in May failed to expand——

Mr. GREENSPAN. I'm sorry. Excuse me, Senator. Are you talking about in United States numbers?

Senator KERRY. In our area.

Mr. GREENSPAN. Oh, you are talking about the GNP for New England?

Senator KERRY. Correct. The nonfarm payrolls in May failed to expand for the third consecutive month. Payrolls fell by 126,000 jobs in April and increased by only 19,000 jobs in May.

Housing starts sank further in May, reaching the lowest level since the recession of 1982. Housing starts were down 1.4 percent in May, down 6.4 percent in April and down 12.2 percent in March.

The credit quality spread appears to be widening. The rate differential between the AAA bonds, the Ba, AA bonds, the lower quality recession sensitive bonds is widening, and we all know about the real estate market in the Northeast and so forth.

Now, given all of that data, it seems to me that the economy is weakening. Do you have any evidence to the contrary?

Mr. GREENSPAN. I think there is a mix in some of the figures which you cite, Senator. Some are national and some are local.

The spread between the Baa and the AAA has opened up very slightly of late, but it's still at remarkably moderate levels in the sense of considering what else is going on in the credit markets.

It is certainly the case that the economy has slowed down. It is puzzling in many respects, because the unemployment rate, as you know, has not gone up as a consequence; indeed, unemployment levels and initial claims are still about where they have been, and the overall unemployment rate is about where it has been for quite a long period of time, which is suggestive of the fact that the labor force growth has slowed down quite appreciably.

We are not quite certain exactly what the dynamics are, but, you are quite correct that the economic growth of this Nation has slowed, and it has slowed in a way which is atypical of the past.

We, needless to say, are focusing very closely on a day-by-day basis, and I spend a good deal of my time trying to get real time analyses as to what is going on, not only for the country as a whole, but in various different regions.

That, for example, New England continues to slow down I think is evident from the data. But, I would certainly not alter what I had said to you the last time we had discussed this.

I still think that coming off the high growth that New England had is a very traumatic experience, and, what is clearly now the case is a slight sag. But, while the unemployment rates in New England are rising—and that is implying that the lay-off rate has gone up significantly—the State of the New England economy is still, I would say, by no means one of extreme depression.

And, I think, as you and others have said, that the resources of New England, its intellectual, technical and other resources, are of the type which one looks favorably on with respect to the longer term. This is a very difficult period to go through. Any type of adjustment of this nature is extremely difficult. But, I think there is every reason to expect that when the adjustment is over, much of the adjustment will be perceived as having created a sounder structure from which to go forward.

Senator **Kerry**. Well, again, the New York Times today refers to the Fed report that came out yesterday which states specifically that the results of the survey of the 12 district banks shows a continued slow growth in the economy with little change in the underlying inflation rate.

And, it refers to the tightness of the grip that you have been keeping on credit to slow the economy and then refers to the fact that many officials, some officials, and economists are saying we have slowed too much and the Fed ought to loosen its grip with respect to the cost of money.

The question is: Given New England's problems—and here I want to try to ask you again to be specific. In light of that report about the national trend, in light of—and I know how closely obviously you watch this, but given the self-fulfilling prophecy syndrome that Senator Dodd referred to and I spoke of earlier, how do—what do you say to people to help break that?

How do you break that cycle? We have a diminished, as you said, labor force. And, we do. It's a very serious problem. We have a tail-off in our high tech industry, computer order, so forth. We have a dissipation of our light manufacturing base over a number of years. We have this very large surplus of real estate with no real immediate absorption capacity because of the other problems in the economy.

So, what kicks that into gear when your real interest rates are at a near all time high?

How do you begin to reduce that cost and give people a sense that investing is worthwhile?

Mr. **Greenspan**. Well, I think that what happens is as the adjustment process continues, significant values re-emerge, and the consequence of that is that potential rates of return begin to go up; I would expect to see that process emerging at some point. I don't want to tell you when, because I frankly don't know, and I don't think anyone really can know the answer to that question.

But, we have seen this type of process enumerable times in the past in various different geographical areas, and, it is a very difficult process to go through.

Senator **Dodd**. John, we promised the chairman——

Senator **Kerry**. Yes. We promised him he would be out of here. So, I need to stop.

Senator **Dodd**. Thank you, Mr. Chairman, very much.

Mr. **Greenspan**. Thank you. I mean, if you——

Senator **Kerry**. I apologize for keeping you.

Mr. **Greenspan**. If you would like me to elaborate further on that specific question, I would be more than delighted to.

Senator KERRY. I would like to, because I also had a couple of other questions.

Mr. GREENSPAN. I am terribly sorry I have to leave.

Senator KERRY. There will be other opportunities.

Mr. GREENSPAN. Thank you.

Senator DODD. Thank you. If I could, and then I will return to John. I have just a couple of additional questions for you.

Mr. CLARKE. Mr. Chairman, do you have any idea how much longer this might run? I'm in a similar bind, in that I'm supposed to be on an airplane to go to a field hearing.

Senator KERRY. Not much longer.

Senator DODD. Not much longer. You will appreciate as well this is an issue of significant interest, as you know. Just a few more.

Mr. Fritts, you had indicated—and I appreciate this, Bob Clarke, as both John Kerry and I know, graciously came up to New England and met with our bankers and suggested to sit down with them to go over some of the problem areas they have.

I wonder if you might be willing to do the same, maybe a bit in advance? I think some of this might have been avoided had we maybe gone through that process earlier, of letting people know what they might anticipate, because obviously in the savings and loan area you are going to be taking a look up there. We would like to invite you to come up and meet with some of these people and give them some sense of what you are going to be looking at.

Mr. FRITTS. I would be happy to do that.

Senator DODD. I appreciate that very, very much. Bob, you met—after our meeting or broader meeting, I know you had an opportunity to meet with some of the bankers, specifically in Connecticut. And, you had invited them to make—if there were particular problems, you wanted to know about it. And, I highly commend you for that.

I can't tell you what a positive reaction it was, by the way, with your presence there and your willingness to sit there and listen to the frustrations of people. It's very important that they be able to talk to someone who is actually a decision-maker in this area and from an agency.

And, I gather from that meeting that there were some specific things mentioned. I was not at the meeting, so I am repeating what I was told.

My hope would be, having invited that kind of comment, that you would be taking a look at those specific items that were raised by the banking community.

You are nodding your head affirmatively, and I presume that's the case.

Mr. CLARKE. Yes, there were some helpful comments made. I appreciated having the opportunity to be with them to hear them made. And, we are taking a look at some of the things that were raised.

Senator DODD. Well, I appreciate that. I don't know whether you got a copy of that survey or not from that Connecticut Business and Industry Association.

Mr. CLARKE. I believe we do have that.

Senator DODD. Oh, you do? Fine.

Mr. CLARKE. Yes.

Senator Dodd. Then, I will make that available to anyone else who may be interested in it.

John, I am through for now.

Senator Kerry. I appreciate it. I will try to be quick. I respect the fact that you want to get out of here. But, I do want to try to get a few of these things done, if I can, quickly.

In testimony before the committee last week, Secretary Mosbacher said of the credit crunch, "It's serious, it appears to be exacerbating. It's not just real estate people. Real estate is very serious. But, it also has to do with the small middle-sized businesses and high-tech across the board who are trying to get loans and can't."

He said the crunch wasn't limited to New England, the Southwest but "is pretty much across the whole country."

Jack Kemp, Secretary of Housing, said, "There is a credit crunch, no doubt about it."

On the other hand, John LaWare has testified saying, you know, the tightening of credit so far has been appropriate. And, you have essentially said that this morning.

If there is a discrepancy within the administration about this, how is the average person going to sort it out? How do we—I mean, is there or isn't there?

What does the administration believe about it?

Mr. Clarke. Senator, the difficult thing, as I think Chairman Greenspan said so well, is to differentiate between what some people perceive as a crunch and what other people may perceive as a crunch. There is a lot of mixed data out there. There is the report that Senator Dodd has just referred to. There was a study done by the National Federation of Independent Businesses, an organization that represents a number of small businesses, which, somewhat to my astonishment I will have to confess, said that there wasn't much evidence of difficulty in getting credit.

Some have said that they can't get credit at all. And, others have said they are having a harder time getting credit but they are still able to get it. That is an important distinction. If the issue is that you have to put more equity into the deals or you have to be personally liable on the loans where you didn't have to before, or you have to provide appraisals or financial statements or whatever, I don't think anyone disagrees that that is important to do and that it may make credit more difficult to get. But if in the final analysis you are still able to get credit, that is a different situation from the borrower who simply can't get credit under any circumstances anywhere.

I think it has to be the case, particularly in markets where there has been a noticeable economic slowdown, that lenders are going to be less willing to lend. They are going to tighten their credit standards and perhaps not lend as much money as they previously were willing to lend. There will be some borrowers who will not be able to get credit under those circumstances. That has always been the case. And, I think it also has to be the case that there will be a reduction in demand for credit.

Senator Kerry. Well, now following on from that then, in the speeches that you have been making around the country, which I think are very important and again I applaud you for them and I hope that process of communication will continue, you have been trying to counter this perception that you are forcing banks to specifically pull back.

And, today you have said, "No. We want them to lend. We want them to lend under creditworthy procedures and so forth."

You have also implored bankers in the area to stand up to the Federal examiners who are reviewing their books if they believe that the examination standards have gone awry.

Can you share with us so that they understand, because a lot of them say, "Sure we stand up and we get clobbered or something happens," you know, how exactly are the banks supposed to stand up to the regulators?

Can you give us a specific sense of that?

Mr. CLARKE. Let me talk about it both theoretically and practically. The theoretical process, of course, is that during the course of an examination and the discussions about the results of an examination, bankers have always had the opportunity to challenge examiners and should challenge examiners if they think there is additional data that can be brought to bear on an issue or if they think the examiner has a misperception about what is going on with a loan or anything else that is relevant. Traditionally, there has also been the opportunity to appeal examiner conclusions about the condition of a bank or its portfolio to the field office or to the district office or even to Washington.

Human nature being what it is, I'm sympathetic to the fact that bankers are somewhat reluctant to do that because they feel that somehow there might be some retaliation. When I used to represent banks which had disputes with bank examiners, I never found any evidence of that, nor did the bankers that I represented, so far as I know, ever feel that they had been retaliated against. But, I understand why somebody would be concerned about that.

The alternative to that is a direct appeal by the banker. And, that kind of process involves structuring on occasion such as the one arranged with the bankers that I visited with in Connecticut or bankers raising directly with me or with others at our senior management levels concerns that they have.

I think it is very important for the standards that we apply to banks to be consistent with what everyone would acknowledge as sound credit underwriting standards. And, I think it's important for all of us, whether it's the OTS, the FDIC, the Fed or the OCC, to hear about it if people believe that we are off-base in that regard.

Senator DODD. Bob, just one second. You know, the FDIC—and I'm not trying to pit one of you against the other here, but I think most of us in New England are hearing about a problem with the Comptroller's office.

I mean, I don't know of any examples where we have had people come up and say it's the FDIC examiners. Could it be that what we are looking at here is traditionally the Comptroller's office deals more with off-site examinations, thereby doesn't have the kind of personal relationships with banks that the FDIC has because of their different approach to examination?

Mr. CLARKE. I don't think so, Senator. For example, in some of the large institutions in New England that have experienced problems with real estate, we have examiners who are in those banks virtually all the time.

Senator DODD. OK.

Mr. CLARKE. I just don't think that's the problem at all. Paul may have some observations.

Senator DODD. There is a difference. I mean, I will be candid. I'm not trying, you know—and there may be a reason for this particularly, but we just haven't—I don't know if John in the Massachusetts example, but we really haven't had the issues raised with the FDIC. Maybe there are other reasons for that.

But, I must tell you candidly that we have not had that. It may be unique to Connecticut, too.

Mr. FRITTS. I guess I could add a couple of comments. For a long time, I was a bank examiner.

And, I made mention of this at a committee meeting the other day, that I did not experience the hesitancy of a banker to challenge an examiner. I mean, during the loan discussion, item-for-item discussion, if the banker thinks that you are off base they tell you that they think you are off base.

And, that has a good effect, because when—all of this plays off of asset classifications, and when we have an examiner severely criticize a bank, the process is that goes all the way through the regional office and other professionals. That examiner has to support his criticism.

It's not just the examiner says, "This is it" and no one else looks at it beyond that. So, when that finding, the findings of the report of examination, goes out, we are fairly confident, at least based on the information the examiner gave us, that that is an accurate portrayal of the bank. And, I'm sure it's the same way with the OCC or OTS or others.

It isn't a case where the examiner can go out there and say, "This is the decision," and it never gets looked at again. So, there is a cross-check in the system.

Now, I would like to just make one comment, Senator Kerry, about your remark about the borrower that went from Boston to New York. When I was an examiner, one thing I noticed was when a borrower—and I'm not saying this is the case in your example. I'm just saying I saw it time and time again.

What a borrower is willing to do related to a long time established credit relationship is one thing. Borrowers are very, very hesitant to sweeten their credit relationship with a bank that they have done business with for a long time under one set of rules.

They think it's a personal attack on their creditworthiness and so forth. But, they will go right down the street—I've seen it time and time again, and certainly they would go to New York. And, I'm not saying this is what happened here.

But, it would not be unusual at all for that second bank to make a line of credit for that gentleman that was substantially different in its underpinnings than what was the case, say, in Boston. That is not an unusual circumstance.

And, it's because of this personal relationship the borrower and the lending officer build up over time. And, they just say, "Hey, if he wants that, he is attacking my creditworthiness, he's questioning my honesty, and I'm just not going to give it to him."

But, in any event, I think that one of the reasons that you've heard more about the OCC than the FDIC in this is the national banks are bigger in New England than the State banks for the most part. And, because of the size, I think that there just naturally is a little closer relationship. You see the President more. He's more available than the President of Bank of New England and that sort of thing.

And, I do believe that the standards are exactly the same and the size of the bank does have an effect on the feeling of being able to go to the examiner and not be inhibited about asking fairly pointed questions. But, that's not just true with State banks. I think it's true with smaller national banks as well.

Senator DODD. I appreciate that. And, I'm sorry, John. I didn't mean to interrupt you.

Senator KERRY. I know, Bob, you've got to go. And, I don't want to hold you any longer. If I could just get a couple of questions in maybe in writing some time and then follow up with you personally, I would appreciate it.

Mr. CLARKE. Sure. I would be glad to.

Senator KERRY. That would be super. Thanks.

Mr. CLARKE. Thank you.

Senator KERRY. And, I would just like to ask a couple of questions of Ryan.

Senator DODD. Bob, again, we appreciate your willingness to be there in the State the other day. And, thank you for being here today as well.

And, we may have additional questions from members as a result of this afternoon's hearing that we may like to send down to you as well.

And, we thank your staff as well. We have not given you much time to do bank examining. We've had you before various groups so many times.

Mr. CLARKE. Thanks very much.

Senator DODD. Thank you very much.

Senator KERRY. Could I just continue for a moment?

Senator DODD. Yes.

Senator KERRY. I will just try to keep the gentlemen for a couple of minutes here if I can.

Mr. Fritts, in early May at a press conference when the government's regular quarterly auction took place, the Under Secretary of Treasury, Robert Glauber, said that the cost of the thrift bailout is "obviously a demand on the market for funds."

Is it true that the raising of money for the RTC is going to add to the overall demand for credit, to higher interest rates, and to what degree are we concerned about that?

Mr. FRITTS. Well, that is an economic question and I'm not an economist. But, it just seems to me the fairly basic thing is that you have so many dollars chasing so much borrowing and the more borrowing that the Government does it should have some impact on interest rates.

Senator KERRY. Is there any thought going on with respect to the current finance mechanism, therefore, the relationship between the availability of credit and the potential for crunch and, therefore, the need to consider perhaps a different way of financing?

Mr. **Fritts**. I know that the Oversight Board as well as the RTC Board have that constantly under consideration. I mean, that's one of their concerns every time that they think additional money is needed.

I can't give you particulars, because I don't have anything to do with the RTC.

Senator **Kerry**. Well, I'm going to—the problem is that having lost a couple of our participants, it's a little hard to pursue this line. But, I really think it's worth our exploring the possibility of forcing an alternative form.

I mean, I understand REFCORP bonding is going out for another $17 billion or something.

Mr. **Fritts**. I think that is right.

Senator **Kerry**. And, I'm very concerned about this long-term payout process and the effect it's going to have on the overall drain of the economy. And, I think a number of us here are beginning to be more and more concerned about this.

I mean, we are dealing with a very different S&L bailout than we were when we first passed FIRREA, correct?

Mr. **Fritts**. In size, yes.

Senator **Kerry**. And, we are dealing with it because the estimates are entirely different, correct? The estimates of the amount are different.

When you folks came to us originally, we passed FIRREA based on $70 or $80 billion; isn't that accurate? Now, we are dealing with $500 billion, who knows what.

It seems to me that that may require a very different approach.

Mr. **Fritts**. But, certainly something you ought to look into, the reason our estimates have changed is strictly because we didn't have sufficient information to go by.

Senator **Kerry**. Is there a reason for that?

Mr. **Fritts**. Well, we didn't have supervision over those institutions and we only have backup responsibility now. But, we have gotten into a great deal of them, and we have a much better feel for what is in those institutions.

Senator **Kerry**. Tim, let me just ask you quickly on the fraud issue, because you are specifically involved in some of that: What steps—what is going to happen now?

Do you concur with my observation that this represents a whole new line that raised the ante a little?

Mr. **Ryan**. I think the public confidence issue is on the mark. To me, from a fraud or enforcement standpoint, it's essential that the administration continue to aggressively ratchet up its enforcement activities.

It is an absolute top priority of the President and of the Attorney General and all of the bank regulators to identify, pursue and punish the people who have abused the process.

In the 2½ months that I've been around, I've seen a significant effort to more closely coordinate the enforcement activities. And, I think the public will see the results of those activities in the very near term.

I would like to also comment on your New York Times' article and the whole issue of asset sales. That is something that the RTC Board will look into very, very closely. I can pledge that to you.

I also have a special concern about service providers who may have contributed to the delinquency of institutions and who are now back providing services to the RTC. And, I don't think that is appropriate either.

Senator **Kerry**. Do you think we should prohibit that, just outright?

Mr. **Ryan**. I think we have to be very sensitive on a case-by-case basis. And, I know my fellow Board members at the RTC found a need for exceptions in the past.

I am not as flexible, quite frankly.

Senator **Kerry**. Well, I think you are going to have a hard time. I would advocate to you that—and we will just close on this note—I was looking at some of the—I think you are going to have a hard time explaining to people—we've got 24 athletic clubs, 16 garages and parking lots, 38 marinas and boat yards, 51 mobile home parks, 13 nursing or retirement homes, 62 ranches and pastures, 162 resorts and golf courses.

You are going to have a tough time letting somebody come back in and operate a golf course and tell some guy in south Boston or somewhere that it's OK for them to have bailed them out, reinstituted them and let them walk off with the profit from that thing. And, I really think that that would be an enormous mistake.

Mr. **Fritts**. I am not RTC, but I will say I don't think they would allow that.

Senator **Kerry**. I beg your pardon?

Mr. **Fritts**. The real problem has been trying to get adequate services for certain things that the RTC needs. I mean, relative to letting them take over property they have owned previously at this bargain kind of a price, I don't think that has happened, to my knowledge at least.

Senator **Kerry**. Well, there is nothing in the system that prevents it.

Mr. **Fritts**. I think—there are names associated with all of those assets. Now, I suppose that if one came in with a different corporate title and they didn't tie the two names together, it's conceivable that could happen.

Senator **Kerry**. Well, that is what the New York Times' article specifically suggested. What they will do is put together a new entity——

Mr. **Fritts**. I see. That's possible. I have not seen that.

Senator **Kerry** [continuing]. And they will create a whole new title. And, unless you have the people to be able to check out who is coming in, you are not going to know the difference. And, you are going to have the X,Y,Z Corp. buying the Y,A,W Corp., and you won't know it.

And, these same people—they can even sit there today and say, "Hey, let's go belly-up and they will put it on the dump and we will come back and pick it up and we will bid for it then."

And, I think you've got to have the personnel in place to prevent that kind of fraud, because I think people find it intolerable.

Mr. **Ryan**. Senator, we have just recently initiated a program to comprehensively review every single institution that has been sent to the RTC to identify individuals who are deserving of the broad prohibition from the entire banking industry.

And, we expect to do that with each institution that is now forwarded to the RTC.

Senator **Kerry**. And, I commend you for that. You know, this is not just—you know, this isn't a Chrysler bailout. This is not just another thing.

This is the biggest financial crisis in the history of the United States. And, it's the biggest single expenditure program today in the United States.

And, if we don't find a way to adequately restore people's confidence about the Government's ability to do this, you are going to threaten, you know, the entire line of things that we need to do in a host of other areas.

So, anyway, I thank you gentlemen. This was not meant to be the longest continuous hearing in history.

And, I thank you for being here. Thank you very, very much. We will stand adjourned.

[Whereupon, the committee stands adjourned at 1:25 p.m., Thursday, June 21, 1990, to reconvene at 2 p.m., this same date.]

AFTERNOON SESSION

The committee met, pursuant to notice, at 2 p.m. in room SD-538, of the Dirksen Senate Office Building, Senator Christopher J. Dodd, presiding.

Present: Senators Riegle, Garn, Dodd, Pressler, and Kerry.

Senator **Dodd**. The committee will come to order.

I want to welcome our afternoon witnesses to the Senate Committee on Banking, Housing and Urban Affairs on the issue of the credit crunch.

Senator Riegle will be here shortly. He is at a meeting I believe at the White House and should be coming back and asked me if I would Chair the hearing this afternoon until he returns.

We have a number of witnesses this afternoon. Congressman Bruce Morrison of Connecticut is due here momentarily

Irvin Maizlish, did I pronounce that correctly?

Mr. **Maizlish**. That's correct, Senator. Thank you.

Senator **Dodd**. The Congressman has come in as I mentioned his name.

And John Shivers, David Cates and Joseph Blair are with us.

Before turning to Congressman Morrison, I will give him chance to collect his breath.

Senator Pressler I know has some comments he would like to make.

Senator **Pressler**. Thank you, Mr. Chairman, I must depart for another committee, but I wanted to say that I have some questions that I wish to submit to Chairman Greenspan from this morning. I have been very concerned about the savings and loan situation, and I'm very concerned that we need to take some additional steps as the situation appears to be worsening.

I know this morning that Chairman Greenspan said that there were some unexplained weaknesses in M2 and M3 which will require continuing scrutiny. In reading the Chairman's statement, I did not understand why the weaknesses in M2 and M3 have occurred. I do not know if this indicates a tightening of credit. I'm especially concerned about credit availability for agriculture and small businesses at rates these segments of the economy can afford. I'm also very concerned about credit drying up around the country for small business, and that is happening.

So I think we have to be very careful in terms of what we anticipate in the step we take. Thank you, Mr. Chairman.

Senator DODD. We left the record open for some questions this morning. So you can certainly submit those questions to the chairman.

Senator DODD. Senator Garn, do you have any opening comments?

Senator GARN. No, I have no opening comments this afternoon.

Senator DODD. Congressman, we welcome you.

Congressman Morrison is a Member of the House Banking Committee and a colleague of mine from Connecticut and participated last week with the visit of the Comptroller of the Currency who was here, and Bob Clarke was here this morning, and we went back over some of the same ground that had been covered at the meeting in Hartford on the issue of the credit crunch.

We welcome you, Congressman. The full text of your remarks will be placed in the record, and you may proceed as you see fit.

STATEMENT OF BRUCE A. MORRISON, MEMBER, U.S. HOUSE OF REPRESENTATIVES, FROM THE STATE OF CONNECTICUT, THIRD DISTRICT

Mr. MORRISON. Thank you, Mr. Chairman, and I very much appreciate your hospitality in allowing me to come and give my views, and Senator Garn and Senator Pressler, I'm pleased to be able to appear before your committee.

I think it's important to underscore that in Connecticut and in the rest of New England there is a credit problem, it is serious, it is not something that can be ignored and we need to focus on it.

It's time that this story of the credit crunch came off the business pages and went onto the front page and, frankly, I think that the headline should read: "Regulator Decisions Are Undermining the Local Economy."

And I think it's time that, despite our reluctance to in any sense suggest that we are interfering with the regulatory process, that we examine the regulatory process. We need to know what the regulators are doing because they appear to have taken steps that have had an adverse effect on working men and women and their prospects.

I would say that after years of laxness the regulatory pendulum is now swinging back with a vengeance and it's attacking the economies of Connecticut and the New England region, and many people are beginning to suffer and more will suffer if we do not deal with it directly.

Businesses that were surveyed in Connecticut have said quite clearly that there is a credit shortage. Statements by regulators that there is no credit shortage are negated by what the people who are actually seeking credit are telling us.

The companies are also telling us that it doesn't make a difference whether they are particularly deffendent in the regional economy or whether they are involved nationally. They are having trouble in securing loans that they need to do business.

And banks have not only stopped making loans, but they have begun to call in loans from their best customers, and when that happens, we know that something amiss is going on, and I think it's important to say that the mathematics of this are quite simple.

We all understand, those of us who have the job of overseeing our banking system, the nature of leverage in that system, and as capital grows, the ability for lending to grow at a ratio of something in the vicinity of 12 to 1 or more.

What we are experiencing now is a dramatic contraction of the capital of our banks in Connecticut and in New England, and with that a contraction at a ratio of 12 to 1 of loans that can be made.

It has been estimated that the loss of capital in New England over the past several months has been approximately $4.5 billion, and the loss that goes with that is over $50 billion in lending capacity.

I have noted in my written testimony a very astute analysis of this coming from Paul Johnson, the president of the Connecticut Savings Bank, who talks about the shrinkage process that is going on and the way in which it works, and the way in which initially there is an attempt to sell off loans and to close the lending window. But that when that process is on its way it doesn't do enough, and the need to shrink means the need to go out to your best customers, those who have cash available and say pay up now so that we can shrink our assets and restore our capital ratio.

That is what is going on in Connecticut right now, and that is what we are hearing about, and what we are hearing about is a real problem. There is no question that there is weakness in the New England economy and there is no doubt that there needed to be some adjustment. It is the speed of the adjustment, the lack of management of the adjustment and the lack of forbearance in the adjustment that is very much of concern.

We have the situation in which performing loans are being classified as nonperforming where interest and principal is being paid on schedule and yet reserves are being required. Those reserves are depleting the capital of the banks involved and cutting back on the ability for new lending to take place.

I think the Shawmut National Bank example is of interest. Out of $1.164 billion in assets that were classified, $330 million of those assets were fully performing under current terms and conditions of the loans. And when you exclude those performing assets from the calculation, the bank was required to take 92 percent reserves against the assets which have been classified as being nonperforming.

These are extraordinary numbers, and they are extraordinary numbers when compared to what was applied in Texas, and they are also extraordinary when compared to how the money center banks have been treated with respect to their Third World loans. Reserves of 25 and 30 percent have been typically required for Citicorp and the other major money center banks against loans in the Third World which are currently on the secondary markets selling for 11 cents, 15 cents, 20 cents. Here we have performing loans being classified. We have loans being reserved against at 92 cents on the dollar. This is an excess overreaction.

I think that in Chairman Greenspan's testimony this morning, despite the always understated nature of a comment from the Fed, we are starting to hear that there is a very real problem here. The statement by the Chairman that classification of doubtful loans can lead to difficult short-run adjustments, that insufficient attention by supervisors in the past is now leading to perhaps a severe crackdown in the present, that credit availability may be significantly impaired in New England, and that impaired credit availability may lead to cutbacks in consumption and in investment. He described the New England situation as "troublesome."

All of those are somewhat veiled ways of saying there is a serious economic problem in New England and in Connecticut today, and that we need more candor on this from the regulators about the downside of their regulatory approach and an exploration of whether there isn't some middle ground between excess laxness, which no responsible person wants, and the harsh treatment Federal regulators are giving our region's financial institutions.

The truth is that you can't produce jobs or homes without credit, you can't keep an economy growing without lending, and you can't strengthen the banks in New England by wrecking the New England economy.

So there is a care and sensitivity required for this process that we are going through. I don't think we have reached that middle ground yet. I think it is a serious worry, and I hope that the hearings that this committee is holding may lead to re-examination by the regulators to their policies.

I believe that there will continue to be attention to this on the House side as well. We expect to have a hearing of the Oversight Subcommittee of the Banking Committee in Connecticut during the month of July, and we will be interested in the conclusions and findings of this committee to help us in that process as well.

I thank the chairman for the opportunity to testify.

[The complete prepared statement of Congressman Bruce Morrison follows:]

For Release:
June 21, 1990, 2 p.m.

Statement of

REPRESENTATIVE BRUCE A. MORRISON

before the

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

of the

UNITED STATES SENATE

June 21, 1990

Mr. Chairman and Members of the Committee on Banking, Housing, and Urban Affairs. Thank you for inviting me to testify on the credit crunch issue.

There's a credit problem in Connecticut. It's real. It's hurting businesses -- both big and small. And it's helping to propel Connecticut into an economic recession.

This is not a story for the business pages. It should be on the front page. And the headline should read: "Regulator Decisions Undermining Local Economy."

I know that it is no longer considered to be very sensible for someone in political life to criticize the activities of the nation's bank regulators. But somebody has got to start standing up for the thousands of working men and women whose jobs and economic well-being are being threatened by a band of zealots who don't understand that it is possible to have too much of a good thing. After years of laxness and regulatory neglect, the pendulum is swinging back at us with a vengeance and the economies of Connecticut and the other New England states are suffering for it.

There is no doubt that there has been a substantial reduction in the availability of credit to all kinds of businesses in the Northeast. I'm not talking about just commercial and residential real estate development. I'm talking about manufacturing, wholesale and retail trade, consumer and professional services, and construction.

The shortage of credit has been documented in surveys conducted by the Connecticut Business and Industry Association, the Small Business Association of New England (SBANE), and the Massachusetts Industrial Finance Agency (MIFA), among others.

And businesses are being squeezed regardless of whether they are particularly dependent on the region's fragile economy. Earlier this week, one Connecticut company reported that it is having its credit lines restricted even though it is having the best year in its history and sells to a national market.

Many banks have not only stopped lending to the business community, but are actually calling loans made to some of their most creditworthy customers. Just what is going on?

Well, what's happened is actually rather straightforward for those with a mathematical bent.

The amount that a bank can lend is a multiple of its capital, about a 12 to 1 ratio for an extremely well capitalized institution. By forcing banks to recognize huge writeoffs, bank capital has been reduced, leading inexorably to a shrinkage in overall lending capacity. One bank analyst has reported that more than $4.5 billion in capital has been wiped off the books of New England commercial banks.

When capital shrinks, banks shrink. And its not just the Bank of New England that's been put on a strict diet.

Connecticut Savings Bank President Paul Johnson, whose bank just announced a significant layoff and will be "downsized" to meet regulatory requirements, described the process in an April 9 letter to one of my House colleagues:

"The early stages of shrinkage produces sales of assets to other financial institutions with little noticeable effects on the local economy. As the process continues, however, the 'downsizing' strategy takes a deeper and deeper bite out of the local economy. Bank management responds by closing the lending window to any and all requests as it accelerates towards its new target size. There is a quick realization that sales and no loans will not produce the desired outcome in a time frame sufficient to meet Regulators' expectations. The final, and most destructive phase comes when the bank begins to call good loans from good customers in order to satisfy the tight time frame requirement."

That's what is going on right now.

There's no question that a lot of imprudent loans have been made -- and good loans gone bad. The banks should have slowed lending to commercial and residential real estate developers much more rapidly as demand began to ease. Many loans have soured -- and that ought to be recognized.

The problem is that the regulators -- who, for all practical purposes, walked off the job in New England for about three or four years -- have not only forced banks in our region to reserve huge amounts for loans that are not current, but also have required reserves against loans that are still current as to principal and interest repayments -- often referred to as "performing non-performing loans."

In effect, what they have done is to force recognition of past, current, and possible future losses in one quarter and required huge reserves to protect against them.

Just how harsh are the regulators being? After its recent examination, Shawmut National Bank reported $1.164 billion or 6.76% of its assets were non-performing, with approximately $330 million or 28% of that amount representing loans that are still current as to principal and interest. It was required to reserve $772 million or 66% of the total assets classified as non-performing. If you exclude the $330 million in "performing non-performing loans," the bank was required to reserve 92% of the value of the loans classified as impaired. There are plenty of other examples.

Contrast that to the treatment accorded to RepublicBank of Texas in 1986 when a loan loss reserve of $307 million was required against $853 million in non-performing assets. Or how about the way that regulators have treated third world debt held by New York's money center banks. Money center banks are carrying reserves of 30 to 40% against loans that often sell for 20 cents on the dollar and less.

I say it is time for a little more candor from the regulators about what they're up to and a little more sensitivity about the impact they're having on the economies of Connecticut and the other New England states.

After all, you can't produce jobs or homes without credit. You can't keep an economy growing without lending. And you can't strengthen the banks by wrecking the local economies in which they operate.

Thank you, Mr. Chairman.

Senator DODD. Well, thank you very much, Bruce, for your eloquent testimony. You have laid out in a very succinct fashion the problem. We have raised it here this morning with the Chairman, and you have accurately described his reaction.

I tried to draw the distinction. If one doesn't want to admit there is a credit crunch, and I provided him with the details of that survey done of 1,400 businesses in Connecticut by the Connecticut Business and Industry Association in terms of their reaction. But clearly you could not argue that there is not a perception of a credit crunch, which may in fact be as devastating as a credit crunch, although I happen to believe we actually are in a credit crunch, and you've pointed out the particular problems that our borrowers as well as lenders are facing as a result of what I think is an overreaction, in my view.

I understand it in some ways given the experience, the recent experience in other parts of the country, but the irony is in effect that we may end up with the same effect for entirely different reasons if we persist in this process, and that would be what is the irony here. We are overreacting to a situation, a highly diverse economy, and obviously there has been a downturn. We all know that, that's normal and cyclical. Real estate, we accept the fact that that is a problem. Real estate people accept that. That's part of doing the business of real estate. There are periods when you overbuild and you allow the market to catch up, and then you build again and that's normal.

What we are talking about here is the testimony of manufacturers, retailers and business people who have nothing to do with real estate whatsoever that are having a very difficult time, if not an impossible time of getting to the credit window, and then when you witness or hear as well about people who are, to call them solvent is to be an understatement.

These are people who have long-standing, two and three decade relationships with lending institutions where their creditworthiness, to suggest that it's not strong is laughable, who are being asked to pay back millions of dollars within 24 and 48 hours are doing so, and borrowing money in the past where their projects have been successful, it's just incomprehensible for anyone to suggest at this point that there is not a real crunch going on when that kind of unprecedented activity occurs.

So I thank you for your comments.

Senator PRESSLER. Mr. Chairman, may I just ask a question?

Senator DODD. Absolutely.

Senator PRESSLER. May I just ask the Congressman what he would see as the worst case scenario if nothing is done?

Mr. MORRISON. Well, I think first of all, just as Senator Dodd has said, the regulators say they haven't told banks to stop lending, but when the effect of what is going on is that the best borrowers are having their loans called in, no bank is out trying to make loans in that kind of a context.

I believe that the worst case scenario is that this will cascade across the country, and that we will see is instead of a macroeconomic Washington-based contraction of credit by raising interest rates, there will be a contraction on a community by community, State by State, and region by region basis. Denial of credit across the country could put us into a deep recession, because in the absence of credit, whether you get there by high interest rates or by the unavailability of credit, you're in the same place. You can't borrow and you can't grow.

Senator **Pressler**. We could go into a very severe recession. It's almost like having a patient, a bleeding patient that you won't give any more blood to. It's just restriction and you think you're going to solve the problem by shutting everything down. So you've raised a very good point here.

Mr. **Morrison**. I think the point is also that you don't save the banking system by having a weak or deteriorating economy. Banks will be in trouble either way, and that's the other half of this problem.

Senator **Dodd**. Any questions, Jake?

Senator **Garn**. No, I have no questions.

Senator **Dodd**. Thank you very much, Bruce, for being here. We appreciate your comments.

Mr. **Morrison**. It's nice to be with you. Thank you very much, Senator.

Senator **Dodd**. The light went on for a vote. I think what I'll do is release my colleagues if they would like, and then I'll stay for a few minutes until the second bells and we can get started.

Why doesn't the panel come up to the table.

If somebody can get back, I would appreciate it and, if not, I'll recess the meeting shortly.

I would ask all of you to join us here, Mr. Maizlish, Mr. Shivers, Mr. Cates and Mr. Blair.

Mr. Maizlish is the president of the International Council of Shopping Centers, chairman of the board of Leo Eisenberg Co., in Kansas City, MO.

Mr. Shivers is the chairman, president and CEO of the Southwest Bank from Fort Worth, TX.

Mr. Cates is chairman of the Cates Consulting Analysts, a Division of Ferguson and Co., from New York, NY.

Mr. Joseph D. Blair is the executive director of the Massachusetts Industrial Finance Agency.

We thank all four of you for being here. I noted from looking out into the audience in the latter part of the morning that you all had an opportunity to listen to, I think all of you did anyway, the witnesses that appeared this morning.

So we take your prepared statements and put them in the record and ask you to proceed.

I'm going to use the clock here, not to shut you off at all, but it's more for our purposes than for yours I think given the tendency of Senators to want to talk more than the witnesses from time to time. So we will try and keep this to about 7 minutes apiece, and if you need more time we'll be liberal in our extension of that credit, so to speak.

We will begin with you, Mr. Maizlish, and we thank you for being here.

STATEMENT OF IRVIN B. MAIZLISH, PRESIDENT, THE INTERNATIONAL COUNCIL OF SHOPPING CENTERS, CHAIRMAN OF THE BOARD, LEO EISENBERG CO., KANSAS CITY, MO

Mr. MAIZLISH. Thank you, Senator. I'm glad you put the time on me because I have a tendency to rattle on.

I have prepared a statement and I hope the committee will record it immediately following my oral statement.

I certainly am honored that this distinguished committee has invited me to appear today before your committee to tell a critical story about our future, and I'm talking about the shopping center industry, and not only the shopping center industry, but as a nation, and your courage for having this committee meeting certainly should be applauded because it's not easy to hold hearings that explore credit problems given the current situation facing the lending industry.

As you indicated, I am Irv Maizlish, and I have been working in the real estate business since I was 30 years old, and I started with nothing. And with the help of my partners, I have worked hard over many years and built the business, which I am very proud of and, needless to say, I am a borrower.

Senator DODD. Mr. Maizlish, the second bells have gone off. I'm going to ask you to suspend for a few minutes. I'll run over and cast a vote, and if someone comes back before me, they can start in, but rather than have you get into this and have me interrupt you right in the middle——

Mr. MAIZLISH. As long as you cast it the right way. [Laughter.]

Senator DODD. You know I'm going to do that. [Laughter.]

[Recess taken.]

Senator DODD. The chairman has arrived.

The CHAIRMAN. The committee will resume.

Senator DODD. Mr. Chairman, if I could just make a statement.

Mr. Maizlish, I ran into Senator Nancy Kassebaum, on the floor on the vote, and she specifically asked that you forgive her for not getting a chance to get over here. She is tied up in another committee hearing, but wanted to extend her warm best wishes to you and regards and to personally thank you for being here today to testify.

Mr. MAIZLISH. Senator, I need her badly because I need three loans in the State of Kansas, and I can't get them. [Laughter.]

Senator DODD. Maybe that's why she is not here. [Laughter.]

The CHAIRMAN. As long as we have had an interruption and before we go forward with your presentation, I want to just make a brief opening comment with respect to this afternoon's meeting, and I think it has some significance beyond just our session today.

Last week during the hearings that we had on U.S. competitiveness here in the committee I asked Commerce Secretary Mosbacher whether or not he thought we were currently involved in a credit crunch.

He responded "Yes" and was very direct about it, and said he would supply a statement for today's hearing. He has done so. He is out of the country today, and otherwise would have been prepared to appear. But in that statement he expresses is personal views on "the increasing difficulties by small and medium sized firms in obtaining credit." Now this is our Commerce Secretary who sits at the Cabinet table.

Among the points that he makes in his statement are the following, and I quote him:

> Especially hard hit have been small and medium sized businesses since these businesses tend to rely heavily on bank loans for their financing.

Another quote:

> While the credit problem differs by region, it appears to be national in scope.

He also cites the following illustrations of what he calls a "credit market-induced investment slowdown."

Then these are other quotes from his statement:

> A survey by the private companies practices section of the American Institute of Certified Public Accountants found that fully ⅓ of the small businesses interviewed were being squeezed by the credit crunch.

Another quote from his statement to us today:

> About 30 percent of the banks in a new Federal Reserve survey said that in the past 6 months they had trimmed the size of credit lines to businesses with annual sales of $50 million to $250 million.

The Commerce Department Secretary furthermore expresses concern about the impact of any credit market induced investment slowdown on our international competitiveness.

So I especially look forward to the thoughts that you may have that would either dovetail with the observations that we have gotten formally today from the Secretary of Commerce, or if you have a contrary view, obviously we want to hear that as well.

But I thought it was very important to make that statement, and we will have his statement available on the press table for general review.

So with that, let me invite you, and I take it that you had just started with your statement; is that correct?

Mr. **MAIZLISH**. Senator, yes.

The **CHAIRMAN**. Very good. Why don't you continue.

Mr. **MAIZLISH**. Thank you.

I am chairman of the board of Leo Eisenberg Co., and our operations are based in Kansas City, and we are involved in sales, leasing, development, construction and management of real estate in over 32 States. Interestingly enough, I have shopping centers in 15 States of the 21 States represented by the members of this bank committee.

More importantly, I am president of the International Council of Shopping Centers, where there are 29,000 members consisting of retailers, lenders, developers and whatever-have-you who are connected with the real estate and shopping center industry.

I was asked by this committee in a letter from Senator Riegle is there a crisis in the real estate business, and there absolutely is, and there is especially a crisis in the shopping center industry.

What caused the crisis, I'm not really sure. We have been blamed for causing a lot of the problems in the real estate industry, but if you look at the RTC and the savings and loan debacle, I'm sure that you will find that there are very few shopping centers per se in that group of real estate that have caused problems for banks and S&L's. I'm absolutely convinced of that.

I do not call a 7-11 store on the end of a corner a shopping center. I don't call 6,000 square feet of small shops in the middle of a block a shopping center. Unfortunately, the same paint brush has painted all real estate. We are not in the real estate business. We are in the shopping center business.

Our industry has grown. We now handle 55 percent of all retail sales in the United States, a small figure of $675 billion. $25 billion in sales tax each year, which goes to the cities and counties, which before this money came from the Federal Government, but since the Federal Government has not sent moneys to the cities and counties, these cities depend upon our shopping centers to help them move along.

As a matter of fact, in one city in Missouri we understand that our shopping center generates ⅓ of the budget of the entire city.

In the first quarter of 1990 shopping center starts were down 25 percent. There are normally 2,000 shopping centers built per year. Obviously that is 500 shopping centers that will not be built, and that will account for 110,000 retail jobs because we know for a fact for every thousand square feet developed, there are 2.2 percent permanent retail jobs established.

Needless to say in addition to that, there are 31,000 construction jobs that will not come around because of the lack of construction.

And as the second quarter comes to a halt at the end of this month, I'm sure that you are going to find that the 25 percent that I talked about will have grown even larger than that.

Let me tell you a few things that have happened in the banking industry which really concern me, and one just happened 72 hours ago to me personally.

A bank president comes into my office, and I have a loan in Kansas City, KS. It was an old center. We took it over. We put in a new Walmart store. The center was almost entirely vacant. We borrowed $4.3 million from this bank, and the Walmart store alone will service all of the debt of this shopping center.

The banker comes in to me and he says, Irv, we would like you to pay down the loan from $4,300,000 to $3,700,000, and I say why? Why should I pay down the loan, it's a good loan. He says, yes, it's one of the best loans I have in the real estate. I said why should I pay it down, and he says, well, the regulators are coming in either the latter part of July or August 1, and I have had conversations with other bankers, and I don't want to have any problem loans.

My comment was, I said, sir, I think the best thing that I should do because it is a very viable loan and there is nothing wrong with it, and he said I admit that, is I ought to move that loan.

His comment to me was please don't move the loan. That presents another problem. I said what is the problem. When you move that loan, then all of the sudden my bank will not be in compliance. Now compliance means I have to make loans of so many dollars within the area in which I serve.

Now it's a Catch-22 and what do you do? Pay off the loan? We have not come to a conclusion of what we are going to do, and we are going to try and figure out something as soon as I get back to Kansas City.

A couple of weeks ago a banker walks into me and says, Irv, we would like you to pay down $250,000 on the two loans that you've had with us. I have only been doing business with this bank for about 14 years. They have never lost a penny on me and everything has been fine. I think my financial statement is worthy of the loans that I have. I have personally guaranteed these loans. And I said why do I have to pay down these loans? Has the real estate deteriorated? He said, oh, not at all, not at all.

So I said why? He said, quite simply, the regulators just left Barnett Bank in Florida and they are coming to my bank next. In my conversation with the bank in Florida they told me what they were looking at, and he says, I don't want to have any problems with the regulators, so please do me a favor, pay down the loans.

Needless to say, through hook or crook I was able to borrow the money the pay down the loans in order to secure and retain that relationship.

This is the situation that is going on all over the country. Believe me, sir, I understand what is going on all over the country. First I said it was only in the Northeast. Since I have nine offices throughout the country, but also, furthermore, since I represent 27,000 members in the United States in the International Council of Shopping Centers, I hear from them every single day.

We took a survey of 500 developers, and 45 percent of the developers who applied for loans in the last 2 months were turned down for loans—45 percent were turned down. That does not cover the amount of people who probably didn't even apply for loans knowing very well they are going to be turned down. These are only construction loans. I don't understand what is going on.

If we had an industry where we had a lot of defaults in shopping centers, then I could understand it. If the interest rates were real high, which they are not, they are not where we want them to be, but we can live with them. If retail sales were down, which they are not, they are up, then what the heck is going on and why can't we continue to build these things. There is definitely demand, and sure, there are areas where we have too many shopping centers.

You don't go into a store and want to buy a shirt and they have to order it off the shelves. Today things are entirely different in the retail industry as they are in every industry. Even today you can't buy a car like you used to 10 years ago because they order it and then it's make back at the factory and you get it in 2 or 3 or 4 weeks.

That's the same way in the shopping center industry today. It's surprising the number of people and the number of retail tenants, major retail tenants who will come in today looking for space and expect to occupy it in August or September or October.

Another serious problem that has occurred is our small tenants. They are unable to borrow money. We have a situation where we have a ladies ready to wear who wants to borrow money for fall operation and Christmas. She can't borrow the money. Now it has a snowballing effect. If she can't borrow the money to buy the goods, that also stops the manufacturer and it stops everybody else.

I see my caution light is on. I just have one closing comment to make.

ICSC supports sound and prudent banking practices which allow commercial banks to lend funds for the construction of shopping centers in appropriate circumstances.

Banking practices should not effectively prohibit such lending based on the faulty analysis that fails to distinguish between different economic situations in different areas of the country and between different types of real estate development.

Please, just judge all types of real estate by their past performance. Use proper cap rates, use proper appraisal processes, don't depend upon a 23-year-old regulator coming in and telling a banker who has been in business for 40 years that he is judging things wrong. That's all I'm asking you.

Thank you very much.

Senator DODD. Thank you very much.

[The prepared statement of Irvin B. Maizlish follows:]

TESTIMONY OF

THE INTERNATIONAL COUNCIL OF SHOPPING CENTERS

on

The Credit Crunch

Presented by

IRVIN B. MAIZLISH
Chairman of the Board

LEO EISENBERG COMPANY
Kansas City, Missouri

to

THE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

of the

UNITED STATES SENATE

June 21, 1990

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SUMMARY

Shopping Centers are as much a retailing business as a real estate undertaking. They are built in response to the expressed needs of retailers to locate in a new market and not on speculation, as is typical of some other forms of real estate. Leases are agreed to before the center can be built and construction and related construction period financing are arranged on the strength of these leases. Such tenants are traditionally called "credit tenants" as a result of this practice. Commercial banks have been the traditional prime lenders for construction of shopping centers. Insurance companies and similar institutions (often pension fund managers) have been the traditional providers of permanent financing of centers.

The International Council of Shopping Centers is the trade association of the shopping center industry around the world. Of our 29,000 members, 27,000 are in the United States. They are developers, owners, managers, retail and service tenants, lenders and others in professions and trades related to centers. There are about 35,000 centers open for business today in the United States.

Almost 10 million people are employed in our nation's centers or roughly 9% of all non-agricultural workers. Centers accounted for an estimated $784 billion in sales, construction contracts and employee pay.

The rise and decline in the number of new centers going under construction each year have historically reflected the expected economic factors -- interest rates, changes in retail sales and similar indicators. By the end of the first quarter of 1990, construction starts had dropped dramatically (25%). This was observed in all regions of the country. However, there appears to be no causal relationship between the decline in number of starts and any other factor except the scarcity of construction financing. Indeed interest rates enter little or not at all in the picture and retail sales are actually up in real terms from year-earlier figures.

Recent surveys of ICSC members about their dealings with the commercial banks and other institutions on loan applications and about their perceptions of future lending practices reveal; among other things that:

- Nearly half of all recent loan applications have been turned down. Given the negative reactions of many bankers when initially approached, a good number of members have decided simply not to apply for loans.

- Existing loan agreements are being modified unilaterally under the terms of the loans to reduce the total amount of credit available or to substantially change the terms of the loans. In some cases, loans are being called.

- Even when loans are approved, the time involved is significantly longer; fees and charges in many cases are higher.

- The expectations of our members about future financing are extremely pessimistic--even on the part of those able successfully to negotiate new loans or to renew existing ones.

The reasons for denying, restricting or forcing the restructuring of loans given by the banks are many and range from concerns about bank director's liability to pressures applied by regulators.

If the roughly 400 centers projected to have been built, (had center construction starts in 1990 not declined so sharply across the nation,) were in fact built, we believe, based on past experience they would have accounted for 31,000 construction jobs on projects worth about $2 billion, retail jobs for approximately 110,000 individuals worth $1.1 billion in salary and wages, and retail sales of $3.8 billion or a grand total of $6.9 billion.

ICSC believes that a credit crunch does exist and that it is getting worse. On existing loans to creditworthy borrowers, credit restrictions and restructurings are resulting in projects being stopped in mid-stream, construction workers being laid off, and entire enterprises being put in jeopardy. This does not result from failure to meet loan terms currently but because of apparent belief (based possibly on what may have occurred in other sectors and in particular in the case of the Savings and Loans) that at some time in the future, the borrower may not be able to meet its obligations. This, to our way of thinking, is a self-fulfilling prophecy. When the major retailer is committed to the project and when the permanent lender is standing in the wings ready and willing to make it possible to pay off the construction loan once the project is complete and leased, actions that stall or prevent the center's completion on time and within budget seem to us to be more than merely ill advised; they're foolhardy.

ICSC urges commercial bankers to continue to make loans to proven, creditworthy borrowers, on the same or similar terms and conditions as they have in the past. To the extent that they have any responsibility for the actions taken by the banks in recent weeks to deny or restrict credit to such borrowers, ICSC urges the regulatory agencies to take corrective action.

In whatever ways possible, we ask the Administration, the Congress as a whole and this committee to move quickly to avert what we believe could and would, if not dealt with promptly, become a major economic problem resulting in loan defaults which have no other reason to go bad than from the effects of the apparent crisis mentality that is influencing lenders to restrict credit to borrowers whose business they only recently competed so aggressively to obtain.

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Statement of
Irvin B. Maizlish
June 21, 1990
Committee on Banking, Housing and Urban Affairs
U.S. Senate

I. INTRODUCTION

My name is Irvin B. Maizlish. I am Chairman of the Board of the Leo Eisenberg Company, which is headquartered in Kansas City, Missouri. We are involved in the sale, leasing, development, construction, and management of real estate, including shopping centers, throughout the United States. I also am President and a member of the Board of Trustees of the International Council of Shopping Centers (ICSC). I am presenting this testimony on behalf of the members of ICSC.

A. Traditional Financing of Shopping Centers

Shopping Centers are built to respond to the need of a major retail tenant to enter a market or expand in a given market through additional locations. Such major tenants are often departments stores, discounters, supermarkets or drug store chains and are typically referred to as "credit tenants" because it is in part on the basis of their having agreed in advance of construction to locate in a center that financing is arranged, traditionally with a commercial bank. Thus, shopping centers, then, are rarely built on speculation as some other forms of real estate are.

Construction loans are usually recourse financing, that is the borrower gives a personal guarantee. Permanent financing, often in the form of a long-term mortgage or equity participation on the part of an insurance company or similar lender, is put in place upon completion of the center. It may be subject to other conditions such as overall leasing ratios. Permanent loans are typically non-recourse in nature.

Except for the smallest projects neither short-term construction nor permanent financing would be available if the retailing plan of the center were not plausible and supported by agreements to lease space made in advance on the part of major and small store tenants alike.

Historically, there have been relatively few defaults on loans made for centers and fewer still bankruptcies of center developers or management companies. In fact, a close examination of the portfolio of the Resolution Trust Corporation will show that contrary to what has been reported in the press, few real shopping centers are among the foreclosed or defaulted loans made by the Saving and Loan institutions. That loans made by commercial banks could be turned into bad loans or defaults because of the actions currently being taken by many bankers in modifying the terms of existing loans, calling such loans and not making loans at all on new projects is the reason for this testimony which shows that:

- There is tightening of credit of such proportion that it can and should be called a "Credit Crunch";

- It is nationwide and not regional;

- It cannot be explained as a reflection of or reaction to economic conditions in most instances since many of the economic indicators (retail sales being the most important in the shopping center field) are positive or holding steady not negative or declining; and

- If credit continues to be tightened on existing loans and lines of credit and if new loans continue to be denied to historically creditworthy borrowers and project,

This credit crunch could be a prelude to and a principal cause of serious economic difficulties for the nation as a whole; indeed it could provoke a recession or worse.

B. The International Council of Shopping Centers

ICSC is the trade association of the shopping center industry. The members of ICSC, consisting of shopping center developers, retailers, investors, managers, and others having a professional or business interest in the shopping center industry, are engaged in the day-to-day activities of designing, planning, constructing, managing, financing, developing, leasing, and owning shopping centers and their retail stores. ICSC has approximately 29,000 members, and the over 27,000 members located in the United States represent a majority of the over 35,000 shopping centers in this country. The Government Relations office of ICSC is located at 1199 N. Fairfax Street, Alexandria, Virginia (703) 549-7404, and ICSC is headquartered at 665 Fifth Avenue, 11th Floor, New York, New York (212) 421-8181.

C. ICSC and the Shopping Center Industry

The shopping center industry is a major contributor to the economic wellbeing of the United States. In 1989, the shopping center industry contributed $676 billion to total retail sales in the United States, an amount representing 55% of all retail sales excluding automobiles and gasoline purchases. The industry employed more than 9.9 million workers, or 9% of nonagricultural employment. The dollar value of construction of shopping centers amounted to $7.4 billion, or nearly 7.5% of total nonresidential construction in 1989. When one includes retail sales, the value of construction, and employment income, the industry contributed an estimated $784 billion to the 1989 economy. This amount does not include such things as: the sales taxes generated by the retail trade, the income taxes collected on employment income, the added construction value from renovations, or any multiplier effects. The inclusion of state sales taxes alone would add another $26 billion to the total.

II. THERE IS A WIDESPREAD CREDIT CRUNCH AFFECTING THE DEVELOPMENT OF SHOPPING CENTERS AND OTHER REAL ESTATE

There appears to be wide agreement that currently there is a significant reduction in commercial bank lending for real estate development throughout the United States. We believe that this reduction in lending constitutes a credit crunch for shopping center development. This is confirmed by a survey of ICSC members which cites significant turndowns and reductions in both loans and lines of credit. This survey also highlights a sudden and unexplained change in existing credit practices by lenders and impositions of onerous new ones. This has had a major negative operational consequences for ICSC members. Further, their expectations for the next 6 quarters remain quite pessimistic with regard to credit availability.

Although some limited portion of this reduction in lending is justified in certain markets, we believe, that much of the reduction is not justified by current economics or normal, prudent lending practices. We have reached this conclusion from the following analysis.

1. In the first quarter of 1990, there was a sharp, and broad decline in shopping center construction starts.

2. This decline is not explainable by economic factors which determine the demand for shopping center construction. In fact, these indicators have been rising.

3. Historically, when shopping center starts have declined in the absence of a decline in these indicators, the decline correlated with tightening of credit, especially by commercial banks which provide most construction financing for shopping centers.

4. Generally, this tightening of credit is not justified by either the economics of the area in which shopping center projects are to be constructed or the credit worthiness of the developer seeking financing.

ICSC supports sound and prudent banking practices which allow commercial banks to lend funds for the construction of shopping centers in appropriate circumstances and do not effectively prohibit such lending, as appears to be the case currently, because of a faulty analysis that fails to distinguish between different economic situations in different areas of the country and between different types of real estate development.

A. Shopping Center Construction Starts Down Sharply

In recent months, shopping center starts are down sharply and broadly. Shopping center construction suffered a major decline in the first quarter of this year: in fact, it was the industry's worst performance since the last recession in 1982. Shopping center starts fell 25% in the first three months of 1990, the sharpest quarterly decline since early 1982. Starts were down in all three months of the quarter compared to a year ago, with the largest decline occurring in February (-35%).

The first quarter declines were widespread, covering all four regions in the U.S. The Midwest and Northeast were hurt the most by the lack of construction activity, with declines of 34% and 33%, respectively. As with the U.S. total, both these regions had the worst declines in eight years. The South was down 21%, while starts in the West fell 15%.

Last year, the top five states for shopping center construction were: California, Florida, Ohio, Illinois, and Michigan. Together, these five states represented a significant 41% of all U.S. starts in 1989. During the first three months of 1990, four of these five states experienced declines: only Florida was up in the first quarter. Ohio, Illinois and Michigan each had declines of roughly 33%, while California was down 13%.

Other major states for shopping center construction which experienced significant deterioration in the first quarter include: Texas, which had no starts (the first time ever since Dodge began collecting data in 1967), Georgia (-50%) and Virginia (-31%).

B. Decline in Shopping Center Starts are Nationwide

Among the 50 states, plus the District of Columbia, 27 had a drop in starts in the first quarter. Additionally, 12 states had no change from a year ago. Thus, 76% or 3/4th of the nation is experiencing weakness in shopping center construction. As already noted, there is no regional bias to the downtrend in the first quarter in shopping center starts. Starts in seven of the nine states in the Northeast were weak, as were 10 of the 12 states in the Midwest, 12 of the 16 states (plus D.C.) in the South, and 11 of the 13 states in the West.

C. The Depth and Breadth of this Decline is not Explained by Economic Factors

The breadth and depth of the widespread and sharp deterioration in shopping center construction starts in the first quarter cannot be explained by a comparable collapse in economic fundamentals which only show some softness verses the recent past. For example:

(1) Real final sales (GNP minus inventories) gained 4.1% at an annual rate in the first quarter, following a 4% rise in the final quarter of 1989 and a 3% increase for all of 1989.

(2) Of direct relevance to the demand for new shopping centers, the consumer has continued to spend: total retail sales rose 6.5% in 1989 and gained 6% in the first three months of this year compared with the same period. And, importantly, sales continue to be up from a year ago in every region of the country.

(3) Finally, the outlook for consumer spending would appear to be favorable since employment grew 2% in 1989 and is continuing to increase in the first quarter.

Thus, despite the continuation of positive economic factors affecting the real demand for new shopping center construction, the actual construction of shopping centers has deteriorated dramatically and significantly.

D. ICSC Survey Confirms Credit Crunch

ICSC has just concluded a telephone survey of more then 500 of its developer members regarding their recent experience in obtaining credit (size of developers for our survey are: small = less than 3 million square feet; medium = 3 - 10 million square feet; large = more than 10 million square feet.) This survey formed the basis for the following conclusions.

1. Credit Experience

ICSC members have been actively in the market for credit for the past 2-3 quarters. Nationwide almost 8 out of 10 members surveyed had made a significant credit application in the past 6 months. The Midwest and East showed somewhat higher proportions of applications, and the polled members in many cases had frequent and serious differences with their lenders. Almost all size categories of developers have been actively in the market for credit with the medium-size developers (owners of 3 to 5 million square feet) showing the highest proportion -- 90%.

A wide variety of loans have been applied for -- the majority by far being construction loans, which represented 58% of loan applications in the sample. However, construction loans accounted for almost 90% of the applications of the medium developers. Permanent financing accounted for slightly under 1 in 5 of the applications, particularly for the middle-sized developer where they accounted for almost 1/4 of the applications.

2. Types of Lending Institutions

The vast majority of loan applications over the past 6 months have been made to commercial banks, which represent over 3 out of 4 loan applications in the sample. This is consistent with historical patterns. Insurance companies run a distant second, representing approximately 1 in 5 of the applications. Applications to S&L's were almost insignificant at 4% of total. The orientation toward commercial banks cut across all regions of the country. Commercial bank applications also cut across almost all size categories, but are particularly predominant in the application of medium developers where they accounted for more than 90% of the applications.

3. Amounts of Loans

" The median amount of loan applied for since the beginning of the year is 6.5 million, with a wide range by region."

4. Status of Applications: Significant Delays

A significant proportion of respondents reported either a refusal to lend and/or protracted delays in the response to their application. In many cases, the loan was left in a "pending" status. Nearly 1 in 2 loans (45%) applied for either had been turned down or was pending. These proportions roughly hold for every region of the country, although they do vary somewhat with the size of the developer, with the smallest developer being most penalized. In the under 1 million square feet category of developer (the ones whose capital structure makes them least capable to withstand a protracted credit crunch), almost 60% of applications were denied or on hold.

As might be expected, significant proportions, 1/3 of respondents, indicated immediate negative impacts to their operations from the refusal or delay in granting financing.

5. Lines of Credit

Lending institutions, at their own initiative, have unilaterally made changes to standing lines of credit affecting a substantial number of respondents. Overall, more than 1 in 3 respondents (in the East, 43%) in all regions of the country were affected by changes in their lines of credit. Sixty percent of medium-sized developers were adversely affected by such cuts.

The median amount of the credit line is $1 million, varying in some degree with the size of operation.

The impact from this unilateral credit line change has been broadly negative for very large percentages of respondents -- almost 8 out of 10 overall. The negative impact include layoffs, restructuring, discontinued operations, abandonment of projects, etc.

6. Lending Climate and Expectations for Credit

Compared to six months ago, the vast majority of respondents reported very significant difficulties in obtaining credit -- a rating of a 6.9 in a 1 to 10 difficulty scale currently versus 40% more difficult currently using a different scale. The smaller developers (less than 3 million square feet) who can least afford a protracted crunch have experienced twice the difficulty of their large counterparts. Mirroring press reports, the East shows the most aggravated rating of 7.9 followed by the Midwest, the South and the West. Interestingly, difficulty in obtaining loans cuts across most size categories with the exception of the largest developers who have had a somewhat easier time obtaining the credit they need (6.7 for large versus of 7.4 for medium size).

Most respondents are fairly pessimistic about a significant change in conditions for the second half of 1990. They are reporting a rating of 7.1 difficulty for both of the next quarters. Expectations for the next 6 months nearly echo their experience of the past 6 months.

Even as the horizon expands to 1991, their expectations essentially remain unchanged, although the East is slightly more optimistic regarding its future.

7. Timing of Credit Crunch

ICSC's members reported that the change in bank lending policies was first noticed in the late 1989, particularly in the East and the Midwest. This intensified considerably in the first quarter of 1990.

8. Justification for Credit Denial

Only 28% of the survey respondents indicated that the area where the project was planned was in an economic downturn. However, in nearly half of those cases (45%), the respondents indicated that bank's denial on this basis was not justified.

9. Effect of Economic Downturn of Developers Credit Rating

Although one-third of the survey respondents reported that the economic downturn has adversely affected their credit rating, over three-quarters reported that this change did not justify the bank's actions in denying credit.

10. Lender Practices

The survey respondents reported a variety of lending restrictions imposed on construction loans:

- 62 percent reported excessive documentation requirements;
- 61 percent reported higher equity requirements;
- 45 percent reported additional collateral requirements;
- 38 percent reported that the amount that would be loaned had been reduced;
- 34 percent reported higher fees imposed by banks;
- 34 percent reported higher leasing ratios;
- 23 percent reported that banks would no longer make any loans to them;
- 21 percent reported that no joint equity ventures would be approved.

11. Lender Explanations for New Restrictions

ICSC's survey respondents reported the following reasons given by commercial banks for more restrictive lending policies on construction and development loans:

- 63 percent reported concern of bank directors for their liability;
- 45 percent reported the new limits on loans to one borrower;
- 36 percent reported tough regulatory action by bank examiners;
- 32 percent reported new commercial real estate lending limits;
- 21 percent reported the new capital requirements.

III. ADVERSE IMPACT ON THE ECONO[illegible]F ARTIFICIAL RESTRICTION ON SHOPPING CENTER DEVELOPMENT

If shopping center construction were to embark on a downward spiral, there, would be negative consequences on the economy in 1990. The shopping centers that were not built would not generate construction income or purchases, and the centers that would have eventually been built would not generate retail income from the workers employed in the centers, nor any retail sales, sales tax revenues, or beneficial multiplier effects in the economy.

Obviously, the longer the extent of a sharp contraction in shopping center construction, the more pronounced the effect on the economy. The longer the contraction, the more difficult the results are to quantify. However, ICSC has estimated a realistic scenario from which some estimates have been made. As a starting point, we have assumed that the 25% drop in starts which occurred in the first quarter equals the full-year 1990 decline. A 25% decline would produce roughly 400 fewer starts, which in turn would mean lost construction income and purchases, including 31,000 fewer construction jobs, with an estimated value of $2 billion.

We conservatively estimated that approximately $3.8 billion in annual retail sales would be lost in retail sales from the shopping centers that did not get built. (We assumed that half the sales were not lost because consumers simply went to another center to make their purchases.) Fewer centers would also translate into lost retail employment (110,000 jobs) and income ($1.1 billion) from workers in the centers. The combined effect on the economy is thus estimated at $6.9 billion from a 12-month decline in shopping center construction. A lengthier downturn of 24-36 months could cost the economy as much as $40 billion, and would obviously be even more onerous to the economy.

As discussed, credit problems encountered by ICSC members are not restricted to a single region of the country. With minor exceptions, the problems encountered cut across location and size. This suggests that a general downward spiral could be underway.

IV. WHY IS THERE A SHOPPING CENTER CREDIT CRUNCH?

As consumers of credit, it is clear to shopping center developers that a credit crunch exists and that in many cases credit is being denied, burdened or delay without regard to the economics of the proposed projects and/or the borrowers.

ICSC members have been told, or have heard from others, many reasons for the credit crunch. And ICSC members are well aware of the debate about whether it is the banker, the bank regulators or the fallout from the S&L crisis or some combination of the above that have precipitated the credit crunch.

For example, ICSC members report that securities analysts of banks have downgraded their options of the stock of banks with significant real estate holdings, despite increases in earnings, which has caused the values of the stock of these banks to fall substantially and has encouraged them to reduce their real estate loan exposure.

ICSC members report that the rating agencies have downgraded their credit ratings of banks with significant real estate holdings, which has increased the costs of borrowing for these banks and has encouraged them to limit their real estate lending.

ICSC members also report that bank lending practices often are characterized by a "heard' instinct, where most banks follow the lead of a few, often without regard to the individual circumstances of a loan application. We understand that the "herd" has now moved from real estate to greener pastures without regard to local economic circumstances or the specifics of a given project.

ICSC members also report that overly aggressive actions of bank regulators have resulted in the credit restrictions. We have heard that several supposed practices of bank examiners have forced banks to restrict real estate lending. For example, examiners have used:

- Unrealistically high capitalization rates (e.g., 12-14% instead of 9-10% that the real estate industry uses to evaluate the value of shopping centers);

- Drastic discounts on appraisals, especially where the permanent financing for a project already is lined up at the appropriate value;

- Unrealistically pessimistic assumptions on lease up, even where anchor stores are already signed up and there is no overbuilding in the shopping center market;

- Unreasonable anticipation of deterioration in market conditions, through unrealistically pessimistic general economic assumptions and real estate market assumptions for a period several years in the future, which are not supported by the current economic situation.

One factor that seems to correlate with the timing of the credit denials and the mechanisms for credit denial is an OCC Advisory which was sent to the chief executive officers and directors of all national banks in February. This advisory, a copy of which is attached to our testimony, may have caused bank directors and lending officers to overreact and establish a policy of avoiding all real estate loans.

However, ICSC members report that the banks have used supposed changes by bank regulators as a pretext for denial of loans for the reasons listed above, or have overreacted to the actions of the regulators.

Members regret that provisions of FIRREA regarding loans to one borrower, bank capitalization, and liability of directors have caused the restrictions on real estate landing.

V. CONCLUSION

ICSC members throughout the country have experienced a sudden, sharp decline in shopping center credit availability. This decline has caused a deep and broad drop in shopping center construction starts, which will have a significant adverse effect on the industry and the economy generally.

Based on construction, economic and lending statistics and on a survey of ICSC members, ICSC has concluded that the source of this decline in credit availability is a credit crunch, not justified in most cases by sound banking practices or economic reality.

ICSC is grateful for the interest of the Committee in examining this important issue and appreciates the opportunity to provide these comments.

# # #

AL 90-2

OCC ADVISORY

Comptroller of the Currency
Administrator of National Banks

TO: Chief Executive Officers and Directors of All National Banks

SUBJECT: Real Estate Project and Development Lending by National Banks

Over the last year, OCC examination activity has revealed a significant number of fundamental deficiencies and negative trends in national bank real estate lending which require the immediate attention of bank managements and Boards of Directors. Our observations fall into three key areas:

Underwriting Standards - Basic lending principles have been ignored or compromised to increase volume and achieve higher levels of interest and fee income. The lack of borrower equity in real estate projects is a critical part of this weakness.

Appraisals, Structuring and Documentation - Appraisal policies are deficient. Too many banks have failed to obtain accurate, independent, and timely appraisals. The absence of proper documentation has often been excused by the need to "meet the competition." After origination, timely reviews of projects and market conditions are not conducted.

Risk Identification - Certain practices have inhibited the ability of lenders to properly categorize risk. These practices include: continuing to accrue interest on loans where interest is being paid from unadvanced loan amounts, despite substantial deterioration in the condition of the project, the market or the borrower; advancing increased interest carry without additional financial support or justification; and operating with incomplete or nonexistent "in substance" foreclosure policies.

Directors should instruct bank management to review carefully real estate lending activities and to initiate corrective action promptly. The OCC has been and will continue to be aggressive in requiring the correction of such weaknesses. Examiners have been instructed to recommend formal enforcement actions as appropriate.

The OCC is currently reviewing its specific guidance on real estate lending (Banking Circulars 208, 225, the Comptroller's Handbook for National Bank Examiners and other issuances on real estate topics). Questions about any of these materials should be directed to your supervisory office.

Nothing in this advisory or in OCC examination policy is intended to discourage sound real estate (project and development) lending. Our supervisory activity confirms that the vast majority of national banks have not deviated from traditional high lending standards.

Robert L. Clarke
Comptroller of the Currency

Senator Dodd. Mr. Shivers.

STATEMENT OF JOHN SHIVERS, CHAIRMAN, PRESIDENT, AND CEO, SOUTHWEST BANK, FORT WORTH, TX

Mr. Shivers. Thank you, Mr. Chairman and members of the committee.

I am John Shivers, president and chairman of Southwest Bank in Fort Worth, TX. I am appearing here this afternoon on behalf of the Independent Bankers Association of America, the only national trade association that exclusively represents the interests of our Nation's community banks.

I appreciate this opportunity to testify regarding the availability of credit throughout the Nation. Although I would like to concentrate on the decline in lending by commercial banks in Texas and its impact on financing the economic recovery of that state, my remarks are equally relevant to other parts of the country.

While we recognize there is not universal agreement on the existence of a credit crunch, we know that there is a growing recognition of the problem.

As the Chairman mentioned, Secretary Mosbacher has said there is a crunch, and I agree with him personally, and it's not limited to regional areas, but it's spreading.

The IBAA has reports from member banks across the country that tend to confirm the existence of a credit crunch. My testimony today is evidence that a credit crunch is in its advanced stages in Texas.

Many community banks have reported that their loan demand has increased in recent months. Ironically, community bankers believe that this loan demand at some smaller banks is increasing due to the cutback on credit at large money center and regional banks. Others report that although they are still making loans, they are exercising extensive caution and are becoming more selective about the credits they grant. Sometimes more collateral is required and more detailed financial analysis. Credits that would have been passed easily a year ago are scrutinized more closely today.

But is there a credit crunch throughout Texas? A recent report prepared by the Banking Department of Texas regarding the volume and trend of bank lending in Texas banks over the past 5 years sheds some light on this question, and that information is attached to my statement.

The causes of the decline in lending are complex, and certainly no one factor is responsible. Some of the more significant issues merit this committee's full attention. One important factor is tightened credit standards, the so-called regulatory overkill, which banks are experiencing.

It kind of reminds me of the story about the farmer and the mule. As a friend watched, the farmer hit the mule right between the eyes real hard with a 2X4, and he asked why on earth did he do that? He said he had to get his attention.

As a Texas banker I have been hit between the eyes by the regulatory authorities, and they do have my attention, my undivided attention.

We have imposed significantly tighter credit standards following extremely stringent exams in an overkill situation, and many bankers, as one of you pointed out, have overreacted by being overcautious due to criticism from exams and, as Irv pointed out, hearing from other bankers what they are looking for, have decreased their lending below an acceptable level. At that point the bank faces further regulatory criticism under the Community Reinvestment Act. So it's a Catch-22 situation for us.

There was a bank in Texas, a small bank, a country bank with a very stable population, and it was very proud of the fact that it had not had any loan losses over a 10-year period. The owners were getting old so they decided to sell the bank, and got an application for a change of control, and up jumps the devil. They had had no loan losses. So, therefore, that was used as evidence that they had not been serving their community needs, and they were forced to loosen their lending standards in order to pass muster on changing control.

One of the most significant problems in Texas is the collecting bank, "junk" bank, or workout bank that has been used in the purchase of most of the large banks in Texas, and in fact in all our large banks and many of the thrifts in Texas. The bidders generally acquire the entire institution, have a long put-back period of any assets they do not want into a collecting or junk bank. This is where most of our major, lending problems are coming from for the small and local businesses of all sizes.

And of great importance to the small businesses is that loans can be shifted to the collecting bank even if they are not in default. Thus, performing loans can be shuffled off to collecting banks. Since the collecting bank is not in the business of extending credit but is there merely to collect the outstanding loans, there can be significant problems for transactions that depend on a revolving line of credit or a draw note which has only been partially drawn down.

To put this in context, let's look at the recent failure of the Chas. Schreiner Bank in the community of Kerrville, TX. This bank was started in 1868. This bank has historically financed the ranching operations in the Texas Hill Country, but had recently branched out into real estate loans. It was closed in April 1990 and converted into a branch of NCNB of Dallas with total assets at year end of $316 million.

By contrast, the other four banks in the Kerrville area had total assets of $227 million. Furthermore, one of those four banks was acquired by NCNB through the failure of NBC Bank of San Antonio in June 1990.

Senator DODD. That NCNB, is that the——

Mr. SHIVERS. That is North Carolina National Bank. The NBC is the National Bank of Commerce of San Antonio that was recently taken over.

Senator DODD. They have traveled up to New England occasionally now.

Mr. SHIVERS. According to the media reports, NCNB cut off all lending at the $20,000 level and placed all loans in excess of that amount in the collecting bank or back to the FDIC. As a result, credit to businesses and ranches in the Kerrville area were significantly reduced. The remaining institutions do not have adequate capital or resources to pick up all the loans which NCNB has put into the collecting institution.

Now this is just one example, gentlemen, and it's one town in Texas, and there have been a number of them, and especially in the farming and ranching areas. It's the same thing that has happened. And there are many other stories.

There is a businessmen's boycott of NCNB in Belton, Temple, Mineral Wells and Wichita Falls. Bank one is modeling its acquisition upon the same lines as the NCNB prototype.

At the same time this processing is going on, the larger institutions are engaging in predatory pricing of deposits from local communities, decreasing the amount of funds available to lend into the community. The vice chairman of NCNB has been quoted in the New York Times as stating that "We're primarily interested in building deposit franchise in Texas," while the Wall Street Journal has suggested that NCNB has no interest in making or carrying loans in Texas.

Finally, Senator Garn, the issue of the lender liability on environmental issues is also of great concern. Some of the recent lawsuits have concerned most lenders. They are scared to death of anything that may even smell like some sort of pollution here or in the future somewhere, and we almost won't touch it, and we need your bill very badly to give us some protection. It's having a dramatic effect on us. The recent Fleet Factors decision has made the need for your bill even greater.

I see my time is up. I would ask again, Senator Garn, for the members of this committee to support your bill.

In summary, the credit crunch in Texas is being brought about in primarily four areas:

The change in lending policies and objectives of the regional holding company banks;

The handling of failed assets being held by the FDIC and the RTC;

The regulatory overkill by the bank regulators; and

The increase in lender liability litigation.

Thank you very much for this opportunity, gentlemen.

Senator Dodd. Thank you, Mr. Shivers.

[The complete prepared statement of John Shivers follows:]

Statement of

John Shivers
Chairman, President and CEO
Southwest Bank
Fort Worth, Texas

for the

INDEPENDENT BANKERS ASSOCIATION OF AMERICA

before the

Committee on Banking, Housing and Urban Affairs
United States Senate

June 21, 1990

SUMMARY OF TESTIMONY

JOHN SHIVERS

INDEPENDENT BANKERS ASSOCIATION OF AMERICA

The IBAA believes that there is a serious credit crunch throughout widespread areas of the nation, and that there is growing recognition of the problem. For example, last week both Commerce Secretary Mosbacher and Housing Secretary Kemp expressed alarm that there is a serious and widespread credit crunch which "appears to be exacerbating." Mr. Mosbacher indicated that the credit squeeze is not limited to regional areas, but is spread across the country. He also stated that it is impacting business other than real estate.

The IBAA has reports from member banks across the country which tend to confirm the existence of a credit crunch. This testimony is evidence that a credit crunch is in its advanced stages in Texas.

Although banks across the country _may_ have both money to lend and creditworthy customers, a number of factors unrelated to these basics are bringing about a "credit crunch."

Reasons why bankers are deciding not to make loan commitments include concerns about certain kinds of loans being out of favor among bank examiners, liability for environmental cleanup costs on the part of lenders, a shift in policies by big banks which put an unfair burden on community banks in meeting local credit needs, and use of a device called a "collecting bank" by regulators in the wake of bank and thrift failures.

The issue of lender liability for environmental cleanups is a recent phenomenon which has significantly affected the health of banks throughout the nation and has resulted in tightened credit standards. Court decisions have led to higher costs for borrowers, refusals to make loans altogether for certain types of businesses, and refusal to foreclose on certain property. The IBAA urges the Committee to support S. 2219, introduced by Senator Garn, which would provide protection to lenders as well as Federal depository agencies from the unjust imposition of cleanup costs for contaminated sites.

Mr. Chairman and members of the Committee, I am John Shivers, Chairman, President, and CEO of Southwest Bank in Fort Worth, Texas. I am appearing before you this afternoon in my capacity as Vice Chairman of the Federal Legislation Committee of the Independent Bankers Association of America (IBAA). The IBAA is the only national trade association that exclusively represents the interests of our nation's community banks.

I appreciate the opportunity to testify today regarding the availability of credit throughout the nation. Although I would like to concentrate on the decline in lending by commercial banks in Texas and its impact on financing the economic recovery of that state, my remarks are equally relevant to the situation in other parts of the country.

We recognize that there is not universal agreement on the existence of a credit crunch. In fact, the industry press recently reported two apparently conflicting surveys. The first is the Federal Reserve System's May 1990 opinion survey of senior loan officers; respondents were generally large banks with assets in excess of $1 billion and many with assets exceeding $10 billion. The second is the National Federation of Independent Business (NFIB) Foundation's monthly survey of small business owners (May 1990). The Federal Reserve's survey provides empirical evidence of a developing credit crunch whereas the NFIB survey refutes evidence of a business credit crunch.

More recently, as reported in a June 15 Wall Street Journal article, both Commerce Secretary Mosbacher and Housing Secretary Kemp have expressed alarm that there is a serious and widespread credit crunch which "appears to be exacerbating." Mr. Mosbacher indicated that the credit squeeze is not limited to regional areas, but is spread across the country. He also stated that it is impacting business other than real estate.

The IBAA has reports from member banks across the country which tend to support the Federal Reserve study's finding of a developing credit crunch. My testimony today is evidence that a credit crunch is in its advanced stages in Texas.

The NFIB Foundation's survey concurs with the Federal Reserve's survey that overall credit demand is down. However, many community banks have reported that their loan demand has increased in recent months. Community bankers believe that loan demand at smaller banks is increasingly due to cutbacks on credit at large, money-center and regional banks. So, as the NFIB Foundation suggests, small business credit demands are being met, but if overall demand increases, there may be a "general availability problem."

Many community bankers report that although they are still making loans, they are exercising extensive caution and are becoming more selective about the credits they grant. Sometimes, more collateral is required and more detailed financial analyses are completed. Loan approval time is gradually expanding to allow for more thorough credit examination and collection of information such as appraisals and industry and economic data. Credits that would have passed easily a year ago now are scrutinized more closely.

The report of the NFIB Foundation is not surprising. The effects of the credit crunch lag its initiation. Many small businesses can continue to satisfy credit needs via previously established lines-of-credit (LOC). At the same time, the Federal Reserve study confirms that larger and mid-sized businesses are moving to other types of credit such as commercial paper.

More specifically, the IBAA believes that the decline in lending can be attributed to the following factors:

- o The regulatory burden and regulatory overkill affecting commercial banks;
- o The unrealistic examination procedures and practices that are being conducted, particularly as these apply to real estate loans;
- o The changes in lending policies and objectives of the regional holding company banks;
- o The massive shift of assets from failed banks into collecting banks; and
- o The proliferation of lender liability suits.

In preparing for my testimony today, I first researched the question of whether or not there is a decline in credit availability in Texas. The news media has been filled with stories from disgruntled real estate developers and businessmen who have been unable to find credit, while there have been contradictory reports indicating that there is no credit crunch. According to bankers around the state, however, it appears that in fact bankers have tightened their lending standards and that credit is less available than in the past.

But is there a credit crunch throughout Texas? A recent report prepared by the Banking Department of Texas regarding the volume and trend of bank lending in Texas banks over the past five years sheds some light on this question. Attached to this testimony is a series of charts showing the distribution of assets and the percent change broken down for all banks in the United States, all Texas banks, state chartered banks, and nationally chartered banks. Several significant observations appear to be justified by the statistics.

- o On a national basis, total bank lending has increased since 1985. However, the rate of increase in construction and land development has declined from a 20% increase between 1985 and 1986 to a 5% increase between 1988 and 1989.

- The volume of lending by Texas banks has decreased since 1985 in almost all categories. The sharpest decline is in construction and land development. However, there was a slight increase recently -- between 1988 and 1989 -- in loans to individuals and a large percentage increase in credit card loans.
- On a national basis, loans as a component of total assets has remained fairly constant with a slight increase in 1989 over the percent in 1985. Similarly, total loans to total deposits has increased in excess of 3% over that period.
- The distribution of Texas assets shows a different trend. Total loans as a percent of total assets has decreased from 60% in 1985 to 47.2% in 1989. Similarly, total loans as a ratio of total deposits has declined from 74.5% to 57.1% over the same time period.

The causes of the decline in lending are complex. Certainly no one factor is responsible. However, some of the more significant issues, from a banker's perspective, merit this committee's full attention.

Regulatory Overkill

One important factor in the tightened credit standards is the so-called regulatory overkill which banks in Texas, and apparently in the northeast, are experiencing. I am forcefully reminded of the story of the farmer and the Missouri mule. As a friend watched in amazement, the farmer hit the mule between the eyes with a two-by-four. The friend said, "Why on earth did you do that?" The farmer responded, "Well, first I have to get his attention!" Many Texas bankers feel like the Missouri mule. The regulators have hit us between the eyes with a two-by-four and now have our full and undivided attention. Banks have imposed significantly tighter credit standards following stringent exams.

We've also learned new concepts. For example, there is the "nonperforming performing loan." We can have a customer who has always performed his obligations in accordance with the terms of the note. However, the transaction will be classified by the examiner. The fact that the customer has never missed a payment and in fact is performing as required is outweighed in the mind of the examiner by current economic conditions or some apprehension about the customer's potential future cash flow, despite the fact that the cash flow has been adequate to service the debt in the past. The result of the classification may be that all credit to this particular customer is cut off. Consider the scene when a bank officer has to tell a customer who has always made his payments on time that the bank can no longer make advances to him. As you might imagine, the customer gets a little hot under the collar and accuses the bank of acting in bad faith.

In some cases banks have perhaps overreacted to criticisms in exams and decreased their lending below an acceptable level. At that point, the bank faces further regulatory criticism under the Community Reinvestment Act. For example, a small country bank was proud that it had no loan losses over a ten-year period. When this history was reviewed in the course of a change in control application, the regulators concluded that the lack of loan losses indicated a lack of appropriate lending in the community! This bank was required to engage in riskier activities in order to serve the credit needs of its area. This case illustrates the need for a balance between the different regulatory concerns, that is, ensuring the safety and soundness of the institution and at the same time meeting the credit needs of the community.

Regulatory overkill can occur in different ways, as a country banker found to his dismay. A small locally-held holding company with six country banks managed to get crosswise with its regulators. In less than five years it was examined 45 times. Outside auditors reported a six-month profit in its last year of operation of $669,723. Over an eight-year period, the six banks had had total loans losses of less than $50,000. However, all of the banks became statistics and were failed as a result of loan write-downs during stringent examinations.

Collecting Banks

Of equal, if not greater, significance is the impact of the collection-bank technique used in the purchase of several failed large banking institutions and thrifts in Texas. Because of the attractiveness to the purchasing party, bidders have generally included this when seeking to take over failed institutions. The procedure works roughly like this. The winning bidder acquires the entire institution at an expedited hearing. Then the winner has an opportunity to do due diligence after acquisition. During this period, the acquiring party can "put" any assets it does not want into a collecting bank, also referred to as a "junk" bank or special assets division. In some cases there are no restrictions on what kinds of loans are put into such a collecting bank, or which are returned to the FDIC or RTC as unwanted. Thus, in the University Savings transaction in Texas, NCNB returned 80% of assets, retaining a mere 20%.

Of greatest importance for small business, the loans can be shifted to the collecting bank even if they are not in default. Thus, performing loans can be shuffled off to the collecting bank. Since the collecting bank is not in the business of extending credit, but is there merely to collect the outstanding loans, there can be significant problems for transactions that depend on a revolving line of credit or a draw note which has only been partially drawn down.

A builder who has started a project may find himself in serious difficulty when his note is "put" into the collecting bank. He is then unable to obtain further credit to finish the project. This will throw the builder into default and in many cases may ultimately result in the builder seeking relief through the bankruptcy courts. Similarly, a farmer with a revolving line of credit for a crop year may have only drawn enough funds to buy seed, and returns to the bank to make a draw for fertilizer and labor only to find that his credit has been shut off. He is also asked to repay everything that has been drawn down to that date. The same treatment has been given to many loans to small businesses.

To put all this into context, let's look at a recent bank failure in a rural community. Chas. Schreiner Bank was an integral part of the Kerrville community. Established in 1869, this bank had historically financed the ranching operations in the Texas Hill Country but had recently branched out into real estate loans. The bank was closed in April 1990 and converted into a branch of NCNB Texas National Bank Dallas. Chas. Schreiner Bank had total assets at year-end 1989 of $316.7 million. By contrast, the other four banks in Kerrville by year-end 1989 had total assets of $227.7 million. Furthermore, one of those four banks was acquired by NCNB through the failure of the NBC Bank system in June 1990. According to the media reports, NCNB cut off all lending at the $20,000 level and placed all loans in excess of that amount in the collecting bank or back to the FDIC. As a result, credit to businesses and ranches in the Kerrville area was significantly reduced. The remaining institutions do not have adequate capital or resources to pick up all of the loans which NCNB put into the collecting institution.

Similar problems have arisen in another Texas community. Stephenville is a town of about 16,000 population. It's the county seat of a primarily rural area. A branch of Texas A&M University is located there. However, dairies, horticulture, and peanut farms, as well as cattle operations, are major sources of income. The community is served by two independent banks and a branch of NCNB Texas. Together the two independent banks have assets of approximately $100 million. In 1988, the predecessor of NCNB had assets of approximately $132 million. According to unofficial sources, the NCNB branch has cut its loan portfolio from about $70 million to about $20 million. Apparently most of the large agricultural credits have been shifted to the collecting bank. According to a dairyman, dairies are not getting funds because "NCNB considers agricultural loans risky." Similarly, one of the major employers in town, who is the head of the local Chamber of Commerce, owns a bowling alley which had its loan "put" into the special assets bank, even though the bowling alley has continued making its payments in a timely fashion. The message is: move the loan -- no more credit is available. Similar stories abound in other Texas communities, such as Abilene, where a group of businessmen are boycotting NCNB. Other boycotts are under way in Belton, Temple, Mineral Wells, Wichita Falls, and other communities.

Certainly NCNB is not the only institution which has taken advantage of the collecting bank system. Bank One, modeling its acquisition upon the NCNB prototype, used a collecting bank as a part of its proposal. Similar problems have emerged as well. Performing bank stock loans have been shifted to collecting banks. For example, a community bank in a south central Texas town had its loan shifted to collecting status in the collecting bank even though the debtors had not merely paid in accordance with the loan agreement but had actually paid installments ahead of time. This move was made after Bank One attempted to negotiate to buy the bank. Similarly, the president of a small south Texas bank had his cattle loan called by Bank One. When he observed that the loan was being paid in accordance with its terms, he was told that Bank One was not interested in agricultural loans and that he should move it.

This creates a credit problem for businesses that try to get a loan elsewhere. All too often a loan's passage through a collecting bank taints it so that other institutions in the community are afraid to acquire the loan, believing that it will automatically be classified at their next examination. A community bank would be forced to either write off a portion of the loan or add to reserves, cutting into its capital. Furthermore, in some communities there is simply not enough capacity to pick up all of these loans. In addition, in some cases the size of the transaction may exceed a local community bank's lending limit. However, in communities with significant independent bank competition, borrowers who are willing to rework their loans are able to refinance and continue in operation. For example, Lubbock, Texas faced a similar problem when the First Republic institution there failed and became a part of NCNB. However, with a variety of aggressive, well-capitalized independent banks actively competing for business, borrowers were able to find alternative sources of financing, unlike in the Kerrville and Stephenville communities.

Draining Deposits

At the same time this process is going on, many of the larger institutions are engaging in predatory pricing for deposits from local community banks and decreasing the amount of funds available to lend into the community. The vice chairman of NCNB has been quoted in the New York Times as stating that, "We're primarily interested in building a deposit franchise (in Texas)." The Wall Street Journal has suggested that NCNB has no interest in making or carrying loans in Texas. We are certainly seeing strong evidence of that. But they are seeking deposits aggressively; local pricing surveys and newspaper advertisements show a difference in rates between the regional holding company banks and community banks of as much as 200 basis points. In many cases this is the difference between profitability and breaking even in a community institution.

The ultimate losers in the David and Goliath tournament are the small businesses that are squeezed by the lack of available credit. Some are failing. Some are simply not expanding, and others are liquidating. Numerous studies have shown that small businesses are the most significant developers of jobs and prosperity for communities. With their small businesses facing this credit crunch, local communities also suffer.

Lender Liability

The issue of lender liability for environmental cleanups is a recent phenomenon which has significantly affected the health of banks in Texas and throughout the nation and has resulted in tightened credit standards. Court decisions have resulted in increasing the costs of applying for, administering and foreclosing on loans, and jeopardizing the fulfillment of fiduciary duties. This has led to higher costs for borrowers, refusals to make loans altogether for certain types of businesses, and refusal to foreclose on certain property.

In Texas, it is fair to say that banks are so sensitized to the possibility of being stuck with cleanup costs that they have virtually cut off all lending to filling stations and convenience stores with gas pumps. This is having a dramatic effect, therefore, not only on the economic development of many communities, but on the very survival of some lending institutions, and by implication, on the safety and soundness of the financial system. It is choking off credit to small businesses and costing the nation an untold number of jobs. It is contributing to the perception of the existence of a credit crunch, and has the potential to make the difference between profitability and failure for many banks. With the Federal government and its deposit insurance agencies in control of many of these properties, it also threatens to greatly increase the taxpayers' burden, either by pinning the cleanup costs on the government or by inhibiting its ability to dispose of properties of failed thrifts.

As bad as this problem is today, it promises to get worse. The recent Fleet Factors decision has significantly expanded the scope of lender liability costs. Previous decisions have held that lenders would only be held liable if they participated in the day-to-day operations of the contaminated property. In this case, the court decided that the creditor does not have to foreclose on the property or to have control over waste disposal, but may be liable merely "by participating in the financial management of a facility to a degree indicating a capacity to influence the corporation's treatment of hazardous waste."

Senator Jake Garn has recognized the magnitude of this problem and has advanced a remedy which would at least address this aspect of the credit crunch. He has introduced S. 2319, a bill which would provide protection to lenders as well as Federal depository agencies from the unjust imposition of cleanup costs for contaminated sites. We strongly support this bill and urge each of you to co-sponsor this important legislation in an effort to pass it this year.

In addition, the Department of Banking for the State of Texas conducted a survey of state banks asking questions relating to the issue of more general lender liability lawsuits. Of the 450 respondents out of a total of 719 state banks, 12% said they were subject to such litigation. The total dollar volume of the actions was $135 million. Of the 53 who said they were subject to a lender liability lawsuit, 35 indicated a dollar amount for an average lawsuit of $3.8 million. Since the average equity capital of a state chartered bank in Texas is $4.1 million, it is readily apparent that the average lender liability lawsuit represents almost 93% of an average state bank's net worth.

Another important by-product of lender liability lawsuits has been the restriction in lending activities by banks which have been sued as well as those which have read about pending litigation. Anxiety over potential lender liability actions frequently has lead bankers to take no action rather than seek recovery on collateral. Ultimately, bankers tend to restrict future lending activities. According to the Department of Banking survey referenced above, 89% of the bankers responding have adopted more conservative lending philosophies than they had five years ago. If a loan relationship is never begun with a customer, the probability of a lender liability action is virtually eliminated. However, the negative effects on economic development are significant according to a report from the Department of Banking to the 71st Texas Legislative Session.

Conclusion

Let me summarize by saying that there is a credit crunch in Texas and elsewhere and this crunch is being brought about by:

1. the change in lending policies and objectives of the regional holding company banks;

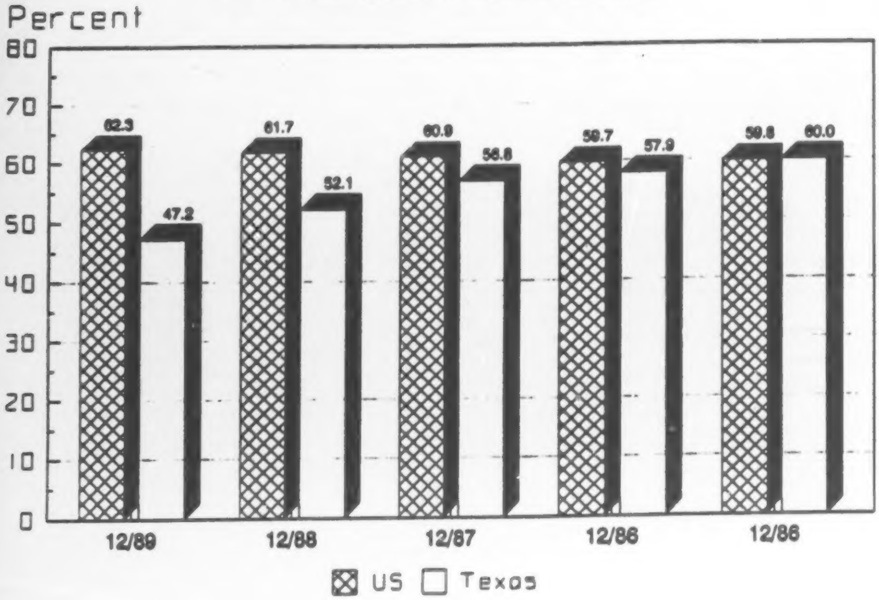
2. the handling of failed assets (loans) being held by the FDIC and the RTC;

3. the regulatory overkill by the bank regulators; and

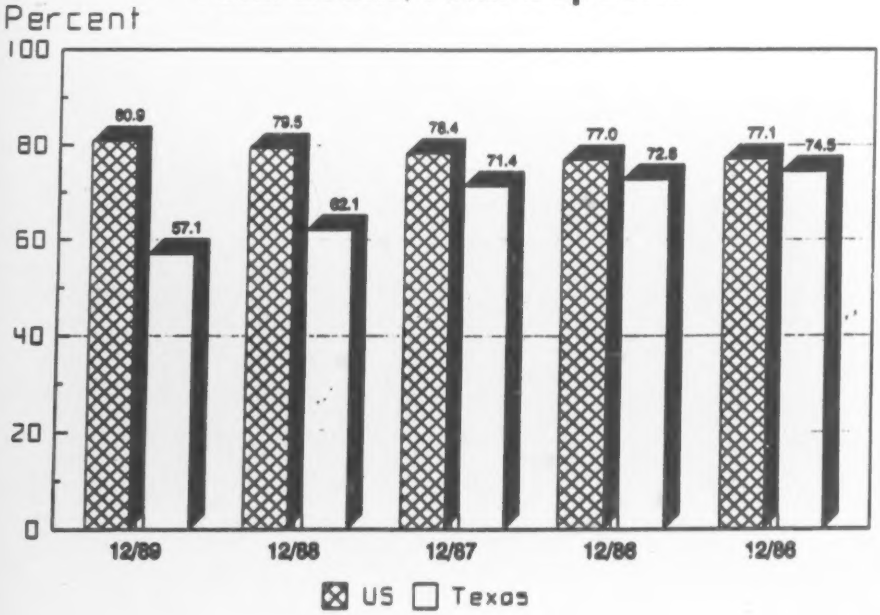
4. the increase in lender liability litigation.

Thank you for this opportunity to bring these concerns to your attention.

Total Loans/Total Assets



Total Loans/Total Deposits



TOTAL UNITED STATES

SCHEDULE I

(In Billions of $)

	12/89	% Change	12/88	% Change	12/87	% Change	12/86	% Change	12/85
Interest Bearing Balances	134	(9)	147	(9)	161	6	152	9	139
Federal Funds Sold	148	16	128	(2)	131	(7)	141	6	133
Trading Accounts	42	17	36	9	33	(23)	43	5	41
Securities	556	4	534	3	518	7	483	11	437
Total Loans	2,050	7	1,922	6	1,819	4	1,749	8	1,624
Total Earning Assets	2,930	6	2,767	4	2,662	4	2,568	8	2,374
Total Assets	3,288	6	3,116	4	2,986	2	2,930	8	2,717
Total Deposits	2,535	5	2,417	4	2,321	2	2,272	8	2,106
Total Liabilities	3,083	6	2,920	4	2,806	2	2,749	8	2,548
Construction & Land Development	136	5	129	8	120	12	107	20	89
Farmland	17	13	15	0	15	15	13	18	11
1 to 4 Family Residential	350	17	300	15	261	18	221	12	197
Multifamily (5 plus) Residential	20	11	18	0	18	13	16	23	13
Nonfarm Nonresidential	215	14	189	13	167	19	140	24	113
Total Loans Secured by Real Estate	738	13	651	12	581	17	497	17	423
Loans to Finance Agriculture Production	31	3	30	3	29	(6)	31	(14)	36
Commercial and Industrial Loans	514	3	497	4	479	(1)	485	9	446
Loans to Individuals	383	6	361	8	334	4	320	8	297
Loans to States, Counties & Municipalities	40	(11)	45	(13)	52	(10)	58	(3)	60
Credit Card Loans	131	12	117	15	102	12	91	17	78
Total Loans/Total Assets	62.3%		61.7%		60.9%		59.7%		59.8%
Total Loans/Total Deposit	80.9%		79.5%		78.4%		77.0%		77.1%

TOTAL TEXAS BANKS

SCHEDULE II

(In Millions of $)

	12/89	% Change	12/88	% Change	12/87	% Change	12/86	% Change	12/85
Interest Bearing Balances	5,763	(4)	6,020	(25)	7,608	(29)	10,706	(7)	11,466
Federal Funds Sold	19,322	32	14,750	(28)	20,576	(9)	22,544	46	15,414
Trading Accounts	250	114	117	(65)	330	(11)	371	10	336
Securities	39,069	11	35,228	11	31,891	7	29,906	(3)	30,712
Total Loans	82,089	(8)	89,094	(17)	107,992	(10)	120,149	(4)	125,378
Total Earning Assets	146,695	1	145,209	(14)	168,397	(8)	183,676	0	183,306
Total Assets	174,094	2	171,082	(10)	190,219(8)	(1)	207,689		209,068
Total Deposits	143,890	0	143,396	(9)	151,239	(8)	165,034	(2)	168,294
Total Liabilities	166,081	2	162,933	(9)	179,910	(8)	195,239	0	195,285
Construction & Land Development	4,148	(43)	7,279	(39)	11,860	(26)	15,982	(6)	16,958
Farmland	982	(7)	1,053	(6)	1,115	2	1,089	10	986
1 to 4 Family Residential	11,289	(1)	11,371	(5)	11,978	(2)	12,229	9	11,219
Multifamily (5 plus) Residential	891	(20)	1,115	(21)	1,410	9	1,289	6	1,213
Nonfarm Nonresidential	12,649	(15)	14,870	(14)	17,266	9	15,872	15	13,755
Total Loans Secured by Real Estate	29,959	(16)	35,688	(18)	43,629	(6)	46,461	5	44,131
Loans to Finance Agriculture Production	2,547	(4)	2,646	(1)	2,680	(2)	2,725	(9)	2,983
Commercial and Industrial Loans	28,033	(2)	28,681	(18)	35,069	(10)	42,643		47,234
Loans to Individuals	14,156	6	13,357	(3)	13,818	(12)	15,650	(10)	17,455
Loans to States, Counties & Municipalities	1,392	3	1,355	(50)	2,685	(10)	2,969	(13)	3,406
Credit Card Loans	974	176	353	4	340	(11)	380	(56)	854
Total Loans/Total Assets	47.2%		52.1%		56.8%		57.9%		60.0%
Total Loans/Total Deposits	57.1%		62.1%		71.4%		72.8%		74.5%

SCHEDULE III

TEXAS STATE-CHARTERED BANKS

(In Millions of $)

	12/89	% Change	12/88	% Change	12/87	% Change	12/86	% Change	12/85
Interest Bearing Balances	1,190	(29)	1,680	0	1,686	(20)	2,109	55	1,362
Federal Funds Sold	4,513	21	3,717	(5)	3,892	(5)	4,091	34	3,062
Trading Accounts	4	300	1	(50)	2	(98)	89	2,867	3
Securities	12,132	4	11,692	13	10,331	13	9,149	(4)	9,545
Total Loans	18,597	(5)	19,665	(9)	21,588	(8)	23,552	(3)	24,375
Total Earning Assets	36,436	(1)	36,755	(2)	37,497	(4)	38,990	2	38,327
Total Assets	40,802	0	40,970	(2)	41,870	(4)	43,721	2	43,070
Total Deposits	36,545	(1)	36,803	(2)	37,541	(4)	38,968	2	38,085
Total Liabilities	37,948	0	38,106	(2)	38,851	(4)	40,451	2	39,640
Construction & Land Development	893	(16)	1,057	(24)	1,391	(22)	1,794	(14)	2,078
Farmland	406	(3)	417	2	408	8	376	11	339
1 to 4 Family Residential	3,256	(3)	3,370	(2)	3,458	3	3,346	10	3,045
Multifamily (5 plus) Residential	188	12	168	(34)	255	(8)	277	17	236
Nonfarm Nonresidential	3,414	(4)	3,573	(8)	3,868	(1)	3,905	9	3,591
Total Loans Secured by Real Estate	8,155	(5)	8,585	(8)	9,380	(3)	9,698	4	9,289
Loans to Finance Agriculture Production	988	(4)	1,034	2	1,018	(3)	1,051	(5)	1,109
Commercial and Industrial Loans	5,107	(3)	5,287	(12)	6,028	(16)	7,196	(11)	8,061
Loans to Individuals	3,800	(2)	3,892	(8)	4,214	(11)	4,747	(7)	5,118
Loans to States, Counties & Municipalities	166	(17)	199	(18)	242	(7)	261	(6)	279
Credit Card Loans	84	27	66	16	57	63	35	(10)	39
Total Loans/Total Assets	45.6%		48.0%		51.6%		53.9%		56.6%
Total Loans/Total Deposits	50.9%		53.4%		57.5%		60.4%		64.0%

TEXAS NATIONAL BANKS

SCHEDULE IV

(In Millions of $)

	12/89	% Change	12/88	% Change	12/87	% Change	12/86	% Change	12/85
Interest Bearing Balances	4,575	5	4,340	(27)	5,926	(31)	8,596	(15)	10,106
Federal Funds Sold	15,009	36	11,034	(34)	16,686	(31)	18,453	49	12,372
Trading Accounts	246	112	116	(65)	328	16	282	(15)	333
Securities	26,937	14	23,536	9	21,560	4	20,757	(2)	21,157
Total Loans	63,492	(9)	69,429	(20)	86,406	(11)	96,597	(4)	101,003
Total Earning Assets	110,259	2	108,455	(17)	130,900	(10)	144,685	0	144,969
Total Assets	133,292	2	130,112	(12)	148,349	(10)	163,967	(1)	165,998
Total Deposits	107,355	2	106,593	(6)	113,697	(10)	126,065	(3)	130,209
Total Liabilities	128,133	1	124,828	(12)	141,058	(10)	154,788	(1)	155,644
Construction & Land Development	3,255	(48)	6,222	(41)	10,469	(26)	14,188	(5)	14,880
Farmland	577	(9)	636	(10)	707	(1)	714	10	648
1 to 4 Family Residential	8,034	0	8,002	(6)	8,520	(4)	8,883	9	8,176
Multifamily (5 plus) Residential	703	(26)	947	(18)	1,155	14	1,012	4	977
Nonfarm Nonresidential	9,234	(18)	11,297	(16)	13,398	12	11,967	18	10,163
Total Loans Secured by Real Estate	21,803	(20)	27,106	(21)	34,249	(7)	36,764	6	34,842
Loans to Finance Agriculture Production	1,558	(3)	1,612	(3)	1,662	(1)	1,676	(11)	1,876
Commercial and Industrial Loans	22,926	(2)	23,394	(19)	29,041	(18)	35,446	(10)	39,172
Loans to Individuals	10,356	9	9,465	(1)	9,606	(12)	10,903	(12)	12,338
Loans to States, Counties & Municipalities	1,226	6	1,156	(53)	2,443	(10)	2,709	(13)	3,128
Credit Card Loans	890	210	287	1	284	(18)	346	(58)	815
Total Loans/Total Assets	47.6%		53.4%		58.2%		58.9%		60.8%
Total Loans/Total Deposits	59.1%		65.1%		76.0%		76.6%		77.6%

CITY NATIONAL BANK OF MINERAL WELLS

SCHEDULE V

(In Thousands of $)

	12/89	% Change	12/88	% Change	12/87	% Change	12/86	% Change	12/85
Interest Bearing Balances	0	(100)	1,099	266	300	0	300	(25)	400
Federal Funds Sold	3,260	3	3,165	55	2,040	(84)	12,510	467	2,205
Trading Accounts	0	NM	0	NM	0	NM	0	NM	0
Securities	46,194	(7)	49,498	1	48,901	56	31,316	(17)	37,751
Total Loans	21,494	4	20,618	(3)	21,302	(25)	28,516	(6)	30,435
Total Earning Assets	70,948	(5)	74,380	3	72,543	0	72,642	3	70,791
Total Assets	75,785	(5)	79,406	3	77,388	0	77,166	3	75,070
Total Deposits	68,390	(5)	71,879	2	70,414	1	69,931	4	67,471
Total Liabilities	69,821	(5)	73,118	2	71,466	1	70,829	3	68,702
Construction & Land Development	53	253	15	(32)	22	(99)	1,821	32	1,384
Farmland	488	(24)	640	(37)	1,009	281	265	(15)	313
1 to 4 Family Residential	7,642	3	7,423	14	6,526	0	6,515	5	6,188
Multifamily (5 plus) Residential	0	NM	0	(100)	469	NM	0	NM	0
Nonfarm Nonresidential	4,248	21	3,498	21	4,131	(15)	6,393	(35)	6,279
Total Loans Secured by Real Estate	12,431	7	11,576	(5)	12,157	(19)	14,994	6	14,164
Loans to Finance Agriculture Production	75	103	37	(40)	62	786	7	(85)	48
Commercial and Industrial Loans	3,962	17	3,392	(12)	3,863	(37)	6,157	(22)	7,849
Loans to Individuals	4,828	2	4,754	40	3,389	(17)	4,062	(17)	4,916
Loans to States, Counties & Municipalities	0	NM	0	(100)	250	(52)	516	231	156
Credit Card Loans	1,328	11	1,196	247	345	808	38	3	37
Total Loans/Total Assets	28.4%		26.0%		27.5%		37.0%		40.5%
Total Loans/Total Deposits	31.4%		28.7%		30.3%		40.8%		45.1%

NM = Not Meaningful

Senator DODD. Mr. Cates, we welcome you.

STATEMENT OF DAVID C. CATES, CHAIRMAN, CATES CONSULTING ANALYSTS, A DIVISION OF FERGUSON & CO., NEW YORK, NY

Mr. CATES. Good afternoon.

As a witness given the honor of appearing today, I would like to set the important question of credit availability into a larger framework.

My perspective is that of an analyst of bank riskiness rather than the perspective of an economist, a banker or a regulator or a borrower.

Since our firm is a bank credit rating agency with some years of experience, I feel that this perspective is relevant to your inquiry. It's relevant because banks depend upon funding in order to make loans and investments.

The kind of funding that allows banks relatively rapid growth is large dollar funding, that is deposits over $100,000 and other nondeposit liabilities. Nominally these funds are insured, but in the wake of the Continental failure in 1984, the large dollar funding has been treated under the too-big-to fail doctrine as assuredly covered by deposit insurance.

We see the problem of tightening credit in New England and perhaps other localities as part of a larger context of bank overexpansion fueled by easy access to large dollar funding, the subsequent contraction of bank credit driven by banks' loss of their own credit ratings and market standards and the eventual recovery of bank creditworthiness after a painful process of rebuilding liquidity, capital adequacy and earning power, and the process is not only painful to banks, but to their borrowers and communities.

The cycle that I have just summarized is essentially driven by private sector forces. The Government intervenes in this cycle, in my opinion, particularly in the latter half of the 1980's by the successive input of adrenalin and arsenic.

The adrenalin is contributed by the post-continental deposit insurance policy which created the too-big-to-fail doctrine. This policy creates complacency and indifference toward the funding of imprudent banks by diminishing the sense of risk that large dollar funds providers ought to feel about where they put their money.

The arsenic is applied when worried regulators seeing that the private sector is not sufficiently vigilant toward its own interests acts to break the overexpansion and to publicly warn all banks not to make similar mistakes.

Unfortunately, this regulatory policy whose basic strategy is understandable, if not benign, is occasionally marred in the execution by heavy-handedness, arbitrariness and unfairness.

The private sector, in my opinion, contains another kind of lapse which the regulators feel the necessity to try to overcome. I refer to the tendency of outside auditors not to discern the buildup of bank risks and therefore to acquiesce in loan loss allowance determinations which are unrealistically low. This extends the overexpansion by postponing the recognition of crisis until even more losses have been incurred.

The first two of these phases, overexpansion and contraction are dramatically evident in a review of the financial history of Bank of New England across the 5 years of 1985 through 1989.

Dramatic examples of the eventual recovery of certain banks, including many without Government assistance, is evident in the return to health of BankAmerica in California and Mellon Bank in Pittsburgh, to name two examples.

I would like to give you my view of the precrisis history of Bank of New England, which remarkably resembles the precrisis history of Continental Bank in Chicago in the years 1979 through 1983, which shows the following five point pathology, which is recognizable after the fact and to a skilled student of bank analysis is also recognizable as it is occurring.

The first point of pathology is progressive deliquification of such a bank accompanied by a high and rising dependence on uninsured funding to make it's overexpansion of lending possible.

Point No. 2 is an increasingly aggressive commitment to corporate and other kinds of institutional lending marked by very rapid rates of loan growth that strain the capacity of lending departments to maintain quality control.

Often the key driver of loan growth is risk kinds of real estate lending. However, rapid overconcentration in any risk arena, whether it's oil, horses, LBO's, LDC's or tanker loans can reek the same damage.

Point No. 3 is the failure of such banks' earnings to respond positively to the aggressive strategy, suggesting that the bank is underpricing its loans in a drive for market share.

I see that my light is turning yellow.

I would like to close by making this point. As the Congress seeks to develop appropriate public policy, my recommendation is to harness the private sector's ability to protect its own interests rather than supplant the market through stringent reregulation.

One measure of the fallacy of reregulation is that since banks are privately owned we should not wish to cause capital flight from bank stocks. I have heard some bank stock analysts refer to bank stocks a little bit like they refer to Hong Kong real estate, is there going to be enough economic opportunity to justify the franchise.

In my opinion, some form of deinsurance of large dollar funding is the best way to harness the private sector to create its own system of mutual vigilance among bankers and their funds providers.

[The complete prepared statement of David Cates follows:]

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IS BANK CREDIT HARDER TO OBTAIN?

Testimony of David C. Cates, Chairman
Cates Consulting Analysts, a division of Ferguson & Company,
before the Committee on Banking, Housing and Urban Affairs
of the U.S. Senate, June 21, 1990.

SUMMARY

This hearing seeks to examine questions such as examination policies and practices, bank over-reaction, whether examination standards are appropriate, and whether there is a tightening of credit.

As a witness given the honor of appearing today, I would like to set these important questions in a larger framework. I do so as an analyst of bank riskiness, rather than as an economist, banker or regulator. Since our firm is a bank credit rating agency with many years of experience, I fee that this perspective is relevant to your inquiry.

We see the problem of tightening credit in New England and perhaps other locales as part of a larger context of (a) bank over-expansion fueled by easy access to large-dollar funding; (b) the subsequent contraction of credit driven by banks' loss of their own credit ratings and market standing; and (c) the eventual recovery of bank creditworthiness after a painful process of rebuilding liquidity, capital adequacy and earning power.

The dynamic summarized above is essentially driven by private sector forces. Government intervenes in this cycle -- particularly in the latter half of the 1980s -- by the successive input of adrenalin and arsenic. The adrenalin is contributed by the post-Continental (1984) deposit insurance policy which created the "too big to fail" (TBTF) doctrine. This policy creates complacency and indifference toward the funding of imprudent banks, by diminishing the sense of risk that large-dollar funds-providers ought to feel about where they put their money.

The arsenic is applied when worried regulators, seeing that the private sector is not sufficiently vigilant toward its own interests, acts to brake the over-expansion and to publicly warn all banks not to make similar mistakes. Unfortunately, this regulatory policy -- whose basic strategy is benign -- is occasionally marred in the execution by heavy-handedness, arbitrariness and unfairness.

The private sector contains another kind of lapse which the regulators feel the necessity to try to overcome. I refer to the tendency of outside auditors not to discern the build-up of bank risk and therefore to acquiesce in loan loss allowance determinations which are unrealistically low. This extends the overexpansion by postponing the recognition of crisis until even more losses name been incurred.

The first two of these phases -- overexpansion and contraction -- are dramatically evident in a review of the financial history of Bank of New England across the five years 1985-89. The eventual recovery -- without government assistance -- is dramatically evident in the return to health of BankAmerica and Mellon, to name two examples.

As the Congress seeks to develop appropriate public policy, my recommendation is to harness the private sector's ability to protect its own interests rather than supplant the market through stringent re-regulation. One measure of the fallacy of re-regulation (a "statist" solution) is that since banks are privately owned, we should not wish to cause capital flight from bank stocks.

Some form of de-insurance of large-dollar funding is, in my opinion, the best way to harness the private sector to create its own system of mutual vigilance among bankers and their funds-providers.

FULL TESTIMONY

Knowledge of credit availability comes from several standard sources: borrowers, lenders, economists and regulators come to mind as obvious witnesses. My professional perspective is quite different from these, yet no less relevant to the topic. What my firm measures is the capacity of a bank to maintain its creditworthiness and therefore its lending presence. To make this judgment, we evaluate the bank's ability to attract and hold stable, uninsured funding, and we look at its risk history as a set of clues toward its risk future. In short, we are a bank risk rating agency. Our clients are uninsured funds-providers seeking to avoid risk and locate opportunity.

The link between lending and funding, of course, is an obvious one, since non-capital funds finance roughly 90% of the financial assets of banks. In the savings and loan industry, a relatively small fraction of the funding base is uninsured funding. In commercial banks, however, a much higher fraction of the funds base is uninsured. In general, the larger the bank, the higher the fraction of large-dollar funding.

In the case of Bank of New England Boston, the lead bank of Bank of New England Corp., some 65% of its financial assets -- loans and investments -- were supported by large-dollar funds during 1988, the last full year before its late-1989 crisis. Thisaggressive funding profile compares to an average 47% among all large regional banks.

Bank of New England also exhibited another aggressive tendency: about 82% of its financial assets were loans, compared to a much lower 74% for other large regionals. Not only that, but its year-to-year growth rates of loans and of large-dollar funding were extremely rapid (respectively, 27% and 37% during 1988, and far more during the super-growth year 1987). Thus this bank was making possible a vigorous lending strategy at some cost to its own liquidity. Borrowers were the temporary beneficiaries of this unsustainable over-expansion.

Bank of New England was not alone in its region. Our studies of Connecticut, Massachussetts and New Hampshire show that during the three years 1985-88, these banks exhibited a non-consumer loan growth averaging 20% per year, as against national averages of 10% per year.

In our view as bank risk analysts, there is an optimum equilibrium among the various types of funding and among the various types of assets, an equilibrium determined by the need to control the several kinds of risk to which banks are prone. There are also optimum growth rates of business loans and uninsured funding, determined by considerations of prudence.

There are four factors which distort this optimum equilibrium in the short run, creating a three-phase cycle of over-expansion contraction, and recovery. I would like to enumerate and illustrate these factors as a framework within which to answer the questions your Committee has posed to the witnesses at this hearing.

1. Greed and fear (the economic names for optimism and pessimism) on the part of bankers, funds-providers and borrowers alike.
2. Complacency and myopia on almost everyone's part, usually followed by over-reaction.
3. Information lags and defects damaging the perceptions of all participants until the underlying economic reality becomes unmistakable.
4. Governmental policies influencing the behavior of all participants, including government.

The complex and often inconsistent workings of these powerful factors are clearly evident across the recent cyclical history of New England banking, just as they were evident earlier in Texas and other Southwestern states. In the first phase, the combination of banker optimism and funds-provider complacency build a climate marked by over-expansion of borrowing, lending and (of course) funding too.

The second phase is a more or less overdue contraction during which banks lose their formerly high credit and investment standing with large-dollar funds-providers -- ranging from depositors to bondholders to stockholders -- and have no choice but to rebuild liquidity, capital adequacy and other signs of creditworthiness as their only avenue to the material renewal of lending.

In the third and final phase of this classic cycle, now evident in some parts of the Southwest, the reconstructed banks enjoy renewed trust on the part of their uninsured funds-providers and help to restore the industries and local economies they helped earlier to damage through too much lending.

Government policies, acting alongside the private sector, serve to administer successive doses of adrenalin and arsenic into this cycle, perhaps more so in the 1980s than before. In my opinion, the chief governmental contribution to bank over-expansion in the 1980s has been deposit insurance policy. By this I do not mean the original policy of the FDIC Act to protect the deposits of small businesses and households. I am referring to the more recent policy to protect banks themselves and thus the financial system. The post-Continental "too big to fail" (TBTF) doctrine induces evident complacency on the part of most large-dollar depositors. Protected by this doctrine, most corporations freely fund the imprudent excesses of banks with no sense of risk to themselves!

It is only natural, in my opinion, for the Comptroller of the Currency (OCC) -- given its oversight of hundreds of very large banks that happen to have national charters -- to be the first regulator to seek to apply a strong brake on the prior excesses of many banks, when neither their managements or funds-providers are exerting sufficient prudence of their own.

The challenge to the regulators is intensified by yet another private-sector lapse. In my opinion, the policies of FASB and AICPA, seconded by actual practice on the part of outside auditors, have consistently failed to provide financial statement information which warn the users of these statements about the real build-up of risk in many banks, bank holding companies and thrifts. In particular, bank managements and their auditors have too often agreed upon loss allowance amounts which history later proves to have been inadequate. Is it any wonder, then, that the OCC should wish to send a signal that loss allowance determination must be more rigorous than before?

Before I illustrate all these points by referring in detail to the recent history of Bank of New England, I'd like to summarize the causes behind the overexpansion of credit, its subsequent contraction, and the renewal of credit availability that explain the cycles evident in the Southwest, later in New England, and possibly now emerging in other regions as well.

1. Overexpansion is induced by borrower enthusiasm, bank management optimism and competitive desire for strong earnings, funds-provider complacency (and ignorance) toward the risk build-up in banks, benign information from accountants, and a TBTF deposit insurance policy that nourishes complacency.

2. Contraction is induced by real losses at banks, bank stock price collapse, credit rating downgrades, dividend cuts and omissions, default on subordinated notes, and by anxious regulators broadcasting harsh signals and forcing accountants to establish more realistic reserves.

3. Renewal is induced by the realistic writedown, workout and disposition of problem assets, by the restoration of liquidity and of capital adequacy, through

downsizing, merging and/or asset sales, by cautious funding and asset policies, by substantially new and different management and finally by the upgrading of credit ratings once the recuperation seems to be established. During the 1980s, this recovery is evident among the banks in the trans-Mississippi farm states, as it is evident in certain banks such as Seafirst, BankAmerica, Mellon and Trustcorp, all of whom recovered without government assistance.

In this paradigm, private sector forces are the pre-eminent drivers of the cycle. Government policy (excluding fiscal and monetary policies) acts upon the cycle in two ways: first, to induce large-dollar funds-provider complacency via TBTF deposit insurance policy; second, to brake and warn banks in the last stages of overexpansion. This braking, though strategically necessary in the context of TBTF, is inevitably accompanied by blunders, unfairness and heavy-handedness as a large bureaucracy attempts to implement a different policy.

I would like now to draw the attention of this Committee to a single illustration of the first two phases of the cycle, namely, the Bank of New England Boston, the lead bank of Bank of New England Corp. Lest you feel that the recent history of this institution is too unique to be typical, I will answer the objection with two points. First, the emerging pathology of BNE across the several years preceding its 1990 crisis bears an uncanny resemblance to the emerging pathology of Continental Illinois in the years prior to 1984. Second, the near-50 crises of large American banks during the decade of the 1980s -- roughly a third of the total population of large banks -- reveal a consistent pattern of symptoms resembling those of BNE and Continental.

Can these symptoms be readily recognized? In my opinion, based on long experience, they can. This science requires two disciplines. One is the close study, one by one, of all bank failures and of all large-bank crises short of failure, in order to find the commonly recurring patterns of disorder -- the signals of pathology -- that precede the publicly recognized crisis. The second requisite discipline is a thorough reconfiguration of conventional financial statements and schedules in order to generate an "alternative accountancy" from which can be derived risk-diagnostic ratios and analytic decision rules. This new accountancy is capable of approximating the true earnings and capital values of banks and bank holding companies, together with their true liquidity, including their power to service debt and maintain shareholder dividends. As for standard accountancy, the shortfalls of its end-product as a risk-diagnostic instrument can be easily documented, though that is a task that falls beyond the range of your interest today.

Using these techniques, the pre-crisis history of BNE (and Continental and many others) shows the following five-point pathology:

1. Progressive deliquification accompanied by a high and rising dependence on uninsured funding.

2. Increasingly aggressive commitment to corporate and other institutional lending, marked by very rapid rates of loan growth that strain the capacity of lending departments to maintain quality control; often, the key driver of loan growth is "risk" real estate; however, rapid overconcentration in any "risk" arena -- oil, horses, LBOs, LDCs, tankers -- can wreak the same damage.

3. The failure of earnings to respond to the aggressive strategy, suggesting that the bank is underpricing its loans in a drive for market share and in the wishful belief that equity kickers (or just more growth) will provide the ultimate justification for the growth strategy.

4. A loss allowance set far too low to offset the rising risk in a high-growth portfolio overconcentrated in particular industries and localities.

5. Cash dividends to holding company shareholders -- and debt service to noteholders -- insufficiently financed by internal cash flows from subsidiaries to the parent. The signifigance of this financial tension is that BHC dividend cuts and/or interest defaults create a visible public event that can damage the funding power of subsidiary banks, thus intensifying the crisis.

When the long-brewing crisis is finally recognized, earnings plunge to deep deficit, the loss allowance surges to recognize the value deterioration of loans, capital is suddenly and severely depleted, funding capacity is impaired, dividends get cut, and the subordinated debt is marked down in the market to a "junk" yield in anticipation of default.

In my opinion, the full extent of such economic damage, as well as its sudden onset, could be greatly lessened -- if not prevented altogether -- by widespread understanding and acceptance of the "alternative accountancy" model of bank/BHC risk. As it is, the standard accounting model has proved itself to be deficient as a guide to risk in financial institutions.

I respectfully offer a recommendation to this Committee toward a public policy which can soften the cycle of credit overexpansion/contraction and at the same time lessen taxpayer exposure to bank crisis. The essence of these recommendations is to encourage the development of mutual vigilance between bankers on the one side and large-dollar funds-providers on the other. Such a policy would recognize that since the private sector plays the major role in over-expansion/contraction/recovery, the power of this existing matrix should be respected and constructively harnessed, not supplanted by government regulation. If, in other words, this complex matrix is over-ridden in favor of governmental remedies such as "re-regulation" in its many forms, an impossible burden is placed on regulatory talents and budgets. In addition, such a statist solution would induce further capital flight from bank stocks. The American banking industry is, after all, privately financed and must look to private investors to underwrite its strategies. Too much regulation would do for bank stocks what the Basic Agreement is doing for Hong Kong real estate. In both cases, the question is whether there is enough investment opportunity to maintain the value of the franchise. If not, who winds up owning it?

EXHIBIT A

C[illegible]S BANCOMPARE ANNUAL DATA/RATIO REPORT

BANK OF NEW ENGLAND NA
BOSTON, MA 01250487
BANK OF NEW ENGLAND CORPORAT
BOSTON, MA 00328

PEER GROUPS:
:BANK $10 BILLION & OVER 45/ 13
:BHC $20 BILLION & OVER 36/ 9

MERGER ADJUSTED

		1 9 8 9		1989	1988	1987	1986	1985
		Nation by Size Peer Group	Region by Size Peer Group					
1.0	**EARNINGS BANK**							
1.01	Return on Assets	0.65%	0.18%	-3.20%	0.99%	0.07%	1.04%	0.98%
1.02	Return on Equity	12.32	2.42	-73.24	21.02	1.58	19.73	19.10
1.03	Pretax Oper Profit Margin	19.72	3.95	-135.12	35.12	2.96	31.13	28.16
1.04	Net Income % Change	-11.28	-42.20	-440.13	1484.72	-90.82	28.89	245.67
1.05	Earning Asset Yield	10.85	10.57	10.77	10.08	10.10	11.74	14.11
1.06	Loan Yield	11.18	10.98	11.24	10.63	10.63	12.57	13.37
1.07	Pooled Cost of Funds	7.18	7.09	8.19	6.41	5.83	6.45	8.48
1.08	Effective Interest Exp Rate	8.32	8.38	8.72	7.06	6.67	8.16	12.56
1.09	Net Interest Margin	3.61	3.30	2.58	3.68	4.27	5.29	5.63
1.10	Oper Inc per Employee	112.71	104.01	112.22	129.06		6.23	6.32
1.11	Overhead to Oper Income	63.35	69.74	69.74	54.38	57.58	59.21	61.96
1.12	Personnel Exp to Oper Income	31.74	32.96	28.93	27.59	30.49	32.31	29.21
1.13	Overhead % Change	6.30	5.86	2.83	4.97	19.26	8.76	8.96
1.14	Net Overhead to Earn Assets	1.81	1.79	1.42	1.39	1.83	2.42	2.63
1.15	Non-Int Income to Oper Inc	33.37	36.68	32.59	26.77	25.84	24.96	28.62
1.16	Loss Provision to Oper Inc	16.79	17.94	165.38	10.50	39.46	9.66	9.88
1.17	Tax-Exempt Inc to Pretax NI	12.27	41.65	-4.95	13.01	218.79	24.31	14.34
1.18	Marginal Tax Rate	37.35	37.12	30.63	42.58	70.16	50.35	45.25
1.19	Sec Gains/Losses (Net) to NI	0.34	1.14	-4.18	4.52	80.92	17.08	7.72
2.0	**LIQUIDITY BANK**							
2.01	Earning Assets to Assets	89.35%	89.55%	93.54%	93.54%	87.82%	74.98%	71.09%
2.02	Large Liability Dependence	38.33	36.48	71.95	62.17	58.55	54.13	59.67
2.03	Invest Secs > 5 Yrs to EA	7.29	4.79	4.79	4.14	3.41	0.89	0.20
2.04	Pledged Secs to Total Secs	59.72	61.84	61.84	70.56	65.41	61.31	89.06
2.05	Invest Secs : Mkt to Book	100.22	99.75	97.51	98.63	97.78	101.05	101.35
2.06	Core Deposit % Change	3.02	2.60	-22.62	13.41	27.57	42.58	15.24
3.0	**ASSET QUALITY BANK**							
3.01	Net Charge Offs to Loans	0.92%	0.77%	1.19%	2.14%	0.27%	0.44%	0.69%
3.02	Gross Charge Offs to Loans	1.13	0.93	1.55	2.22	0.37	0.52	0.87
3.03	Recovs to Gross Charge Offs	17.09	12.04	23.55	3.53	26.94	16.90	20.42
3.04	Earnings Cov of Loan Losses	2.67x	2.19x	1.26x	1.26x	10.78x	8.64x	6.16x
3.05	Loan Mix : % Retail	25.11%	31.09%	8.09%	11.97%	14.29%	15.26%	9.97%
3.06	OREO to Loans + OREO	0.24	0.25	1.37	0.06	0.03	0.00	0.03
3.07	Non-Perform Loans to Loans	2.75	3.41	10.03	1.82	2.34	1.97	2.52
3.08	Non-Perform Ex 90 Days to Lns	2.29	3.05	9.91	1.72	2.24	1.74	2.32
3.09	Loss Allowance to Loans	2.17	2.03	7.94	1.26	3.12	1.22	1.28
3.10	Loss Provision to NCOs	131.44	131.44	647.46	29.92	1025.76	195.68	158.82
4.0	**CAPITAL BANK**							
4.01	Equity to Total Assets	6.69%	4.55%	1.48%	4.65%	4.73%	5.30%	5.12%
4.02	Primary Capital to Assets	7.09	6.98	7.06	6.11	7.41	6.23	6.32
4.03	Risk Adj Assets to Assets	82.83	76.06	103.66	91.26			
4.04	Term Debt to Tot Capitalization	17.53	15.19	57.91	17.78	20.70	11.36	12.59
4.05	Cash Dividend Payout	33.99	31.79	-3.50	7.22	0.00	2.31	9.65
4.06	Capital Formation Rate	3.13	-5.40	-67.36	21.78	1.65	26.66	-4.32
4.07	Asset % Change	4.67	5.32	5.32	19.74	26.58	20.60	18.06
5.0	**BALANCE SHEET BANK**							
	% Change :							
5.01	Temporary Investments	0.80%	10.34%	30.40%	54.94%	25.10%	-36.92%	18.38%
5.02	Investment Securities	4.78	5.54	4.74	32.40	44.83	-11.94	17.51
5.03	Loans	6.42	10.39	5.06	26.54	51.34	31.06	28.50
5.04	Non-Retail Loans	6.69	9.70	9.70	29.96	51.98	24.31	28.99
5.05	Demand Deposits	-1.31	-4.02	-12.98	3.40	0.87	22.51	3.45
5.06	Other Core Deposits	6.42	5.05	-26.88	18.68	50.16	70.87	28.21
5.07	Large Liabilities	8.52	12.10	19.95	37.06	76.04	7.49	38.18
	As % of Earning Assets :							
5.08	Temporary Investments	12.91%	8.87%	8.49%	6.86%	5.64%	8.56%	15.44%
5.09	Taxable Investments	11.78	15.60	9.69	12.38	12.21	10.57	8.40
5.10	Tax-Exempt Investments	2.70	3.06	1.93	1.25	1.27	2.18	1.56
5.11	Loans	74.26	74.26	82.27	82.47	83.12	79.80	70.76
5.12	Demand Deposits	16.57	18.87	9.51	11.80	15.30	24.51	25.45
5.13	Other Core Deposits	34.78	37.72	18.07	25.74	26.91	24.27	12.22
5.14	Large Liabilities	47.37	[illegible]	74.52	65.43	60.89	54.33	60.96

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		1989 Nation by Size Peer Group	1989 Region by Size Peer Group	1989	1988	1987	1986	1985
6.0	HOLDING COMPANY CONSOLIDATED							
6.01	This Bank to : Consol Assets			48.44%				
6.02	: Consol Net Income			42.34				
6.03	All Bank(s) to Consol Net Inc	100.90	97.45	99.82	100.59	107.21	109.47	109.87
6.04	Non-Bank Inc to Consol Net Inc	2.86	4.89	0.29	-0.14	0.65	-4.78	
6.05	Parent Inc to Consol Net Income	-4.31	-0.10	-0.10	-0.45	-7.86	-4.69	
6.06	All Bank(s) Dividend Payout	45.54	48.02	-13.35	22.99	20.66	6.86	14.99
6.07	Non-Bank Dividend Payout	35.79	0.00	0.00	0.00	1.10	-52.71	-730.93
6.08	Consol BHC : Return on Assets	0.79	0.54	-3.55	0.92	0.54	0.85	1.07
6.09	: Return on Equity	13.04	10.10	-81.26	18.06	10.76	17.15	22.04
6.10	: Net Income % Change	-8.43	-16.84	-495.26	100.40	-18.19	30.96	-95.52
6.11	: Net Charge Offs to Loans	1.12	0.96	1.68	1.16	0.26	0.29	0.70
6.12	: Non-Perform Loans to Loans	2.81	3.21	8.49	1.79	1.87	1.73	
6.13	: Loss Allowance to Loans	2.14	2.19	6.52	1.30	2.16	1.28	1.28
6.14	: Equity to Assets	5.61	6.12	1.55	5.10	4.96	5.13	4.78
6.15	: Term Debt to Tot Cap'n	41.96	30.95	62.99	23.95	26.71	23.19	26.64
6.16	: Cash Dividend Payout	33.07	40.43	-6.56	33.53	60.36	33.01	33.02
6.17	: Capital Formation Rate	7.33	1.97	-72.30	12.81	4.05	13.39	25.89
7.0	HOLDING COMPANY PARENT ONLY			BANK OF NEW ENGLAND NA				
7.01	Fixed Charge Coverage	1.54x	4.15x	3.12x	2.[illegible]x	1.24x	0.90x	1.22x
7.02	Cash Flow Match	0.94	0.93	1.54	0.85	0.60	0.61	0.72
7.03	: Ex Current Portion LTD	1.06	1.01	1.54	0.85	0.60	0.61	0.72
7.04	Double Leverage	111.44%	107.49%	170.55%	113.66%	111.43%	106.46%	116.85%
7.05	Double Leverage Payback	1.40y	1.79y		1.15y	2.85y	0.60y	1.48y
7.06	Liabilities to Net Worth	120.94%	28.64%	173.35%	35.61%	41.00%	35.88%	56.23%
7.07	Term Debt to Tot Capitalization	36.13	16.09	60.68	21.81	23.99	20.20	14.38
	As % of Parent Assets :							
7.08	Financial Assets	7.20%	3.54%	3.54%	1.77%	5.92%	3.59%	0.93%
7.09	Loans and Advances : Bank(s)	5.97	8.15	31.17	11.49	13.35	8.42	7.13
7.10	: Non-Bank	12.60	0.14	4.75	2.49	0.99	8.93	17.96
7.11	Equity Inv in : Bank Subs	47.06	80.48	52.83	79.71	74.59	71.89	66.59
7.12	: Non-Bank Subs	3.98	4.74	0.86	0.72	0.57	0.72	1.33

8.0	BANK DATA (000)	1989 less '88	1989	1988	1987	1986	1985
8.01	Average : Total Assets	745119	14738766	13993647	11686899	9119993	7562034
8.02	: Temporary Investments	272775	1170111	897336	579166	585420	830186
8.03	: Other Investments	-162042	1274839	1436881	1183895	710211	357298
8.04	: Loans	546645	11341831	10795186	8530723	5457212	3803433
8.05	: 1-4 Family Mortgages	-265128	463700	728828	775034	674185	392536
8.06	: Core Deposits	-1111431	3801916	4913347	4332255	3335495	2024835
8.07	: Large Liabilities	1708417	10273275	8564858	6249111	3715260	3277084
8.08	Year End : Total Assets	-1271445	14292638	15564083	13327632	10598602	8782841
8.09	: Fixed Assets	2492	173471	170979	150443	135244	112690
8.10	: OREO	145707	152662	6955	3235	119	1876
8.11	: Capital Debt	117042	251168	134126	128665	44180	43731
8.12	: Mortgage Debt	17769	40299	22530	25411	23652	19131
8.13	: Loss Allowance	723364	873702	150338	313547	99897	74042
8.14	: Equity	-512414	211835	724249	590329	529403	436451
8.15	: Non-Performing Loans	887733	1104196	216463	237473	164210	146687
8.16	: Gross Charge Offs	-63121	176140	239261	31152	28643	33126
8.17	Operating Income	-130325	527212	657537	591630	482392	423850
8.18	Loss Provision	802817	871882	69065	233474	46576	41868
8.19	Overhead	10106	367677	357571	340641	285634	262629
8.20	Pretax Net Income (Book)	-924816	-702714	222102	11928	159062	120391
8.21	Sec Gains/Losses (Net of Tax)	13428	19693	6265	7076	16282	5709
8.22	Net Income	-609948	-471364	138584	8745	95299	73941
8.23	Extraordinary Items	0	0	0	0	0	0
8.24	Dividends	6500	16500	10000	0	2200	7135
9.0	HOLDING COMPANY DATA (000)	1989 less '88	1989	1988	1987	1986	1985
9.01	Consol BHC : Total Assets	-2697149	29503278	32200427	29474763	22472935	17803573
9.02	: Net Income	-1394931	-1113277	281654	140545	171803	131189
9.03	Parent Only : Total Assets	-973671	1251252	2224923	2060344	1565607	1329481
9.04	: Financial Assets	4991	44306	39315	121992	56226	12423
9.05	: Loans and Adv to Subs	138461	449520	311059	295559	271574	333517
9.06	: Equity Investment in Subs	-1117714	671801	1789515	1548565	1136756	903064
9.07	: Goodwill	-2413	63850	66263	71478	84382	78148
9.08	: Short Term Debt	-31882	53788	85670	77025	73276	293817
9.09	: Long Term Debt	248738	706423	457685	461137	291713	142918
9.10	: Net Worth	-1182951	457748	1680699	1861187	1152163	850962

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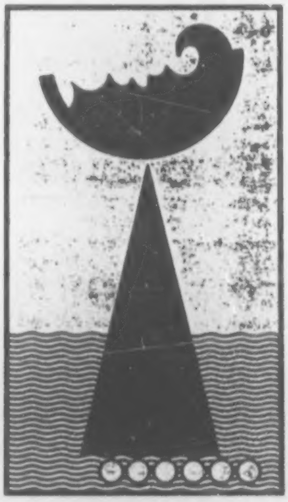
EXHIBIT B

Liquidity Lessons for the '90s

The "too big to fail" doctrine comes under question.



By David C. Cates

In 1977, Donald Howard, then the Chief Financial Officer of Citicorp, told a group of analysts what he thought of the "CAMEL" rating system. He said, "I like it, but it's backwards! It should be 'LEMAC.' Liquidity always comes first; without it, a bank doesn't open its doors; with it, a bank may have time to solve its basic problems."

Citicorp itself had just come through a bad time, as had a few other large banks. Years later, in an *Institutional Investor* article about his experiences funding Citicorp in 1974-75, Howard admitted there were days during that period when he wondered how he would obtain the funding.

Robert Abboud, in *Money in the Bank* (Bank Administration Institute: 1988), described a similar mid-1970s emergency at First Chicago, a crisis that required an abrupt braking of the 16-cylinder leading engine built by his predecessor, Gaylord Freeman. And in May 1984, the greatest banking liquidity crisis of all time overtook Continental Illinois.

This failure was so traumatic that the government—the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Federal Reserve Board and the Treasury Department—created the "too big to fail" (TBTF) doctrine. This doctrine guarantees the worldwide liquidity of U.S. banks. The FDIC includes smaller banks under the TBTF umbrella on the principle of fairness, driven by litigation avoidance.

Lessons for the '90s

These recollections have value for the 1990s. Illiquidity, already a historic reality, will become a chronic issue in years to come for two reasons. First, the "crisis rate" among large U.S. banks has become far too high, a fact that disturbs public confidence in banks. The summer 1989 issue of *The New England Economic Review*, published by the Federal Reserve Bank of Boston, documented 40 crises from 1980 to 1988 among bank holding companies (BHCs) over $2 billion in assets. We can easily add six 1989 examples, culminating in the year-end flame-out of the Bank of New England.

The decade total of 46 is an astonishingly high number, one that is nearly one-third the total number of BHCs with over $2 billion in assets as of the mid-1980s.

It is wishful to argue that the high crisis rate of the 1980s is a fluke. The financial risk environment remains too uncertain and the propensity to mismanage banks is still too widespread.

Second, public confidence in the

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TBTF doctrine will diminish. For one thing, the "nominally uninsured" funds-providers (by statute, you're insured only if you have a deposit balance of $100,000 or less in a bank) will become increasingly anxious about the integrity of the FDIC fund, as the high crisis rate continues. Also, the government itself (Congress prodded by Treasury) will in 1991 begin ever so slightly to roll back the TBTF policy. The Bush budget message of January 1990 contains a signal that TBTF coverage is a dangerous national policy. News of this sort will create sufficient uncertainty in the minds of uninsured funds-providers to create a market-driven brake on risky expansion by banks and BHCs. This perception could, of course, also create a lemming-like "flight to quality" unless carefully and gradually introduced.

You may disagree with my two premises for the 1990s. If so, liquidity will remain a nonissue for you. The government, in your view, will continue to guarantee the worldwide liquidity of a basically stable U.S. banking system. If, on the other hand, you agree with my two premises, bank liquidity must then emerge as a key issue for the 1990s. This is because the mutual vigilance of banks and their large-dollar funds-providers—a process called "market discipline"—will become more intense.

In discussing liquidity, three basic questions should be kept in mind:

- How are we to define "liquidity"?
- What are the entities whose liquidity we need to measure?
- What standards of liquidity should either creditors or managers apply to the entities?

Defining Liquidity

Almost every banking textbook—reflecting banking principles stemming from the 12th century in Venice—defines liquidity as the "ability to meet obligations." This definition needs refinement and adjustment to the times if it is to be useful.

In the discussion that follows, the viewpoint of the "private sector"—analysts, funds-providers, investors and bankers—will govern, rather than the mere concept of compliance with regulatory definitions and standards. If a bank can document a sound liquidity program that makes sense to creditors, the plan can be sold to regulators. If, on the other hand, bankers merely follow regulatory definitions, such compliance will likely result in needless damage to shareholders, possibly even to creditors as well.

If a bank can document a liquidity program that makes sense to creditors, it can sell it to bank regulators.

Defining Obligations

The bare-bones Venetian definition needs three adjustments to our era:

- What do we mean by "obligations"? Prior to 1934 (the FDIC Act), a bank was at hazard for all its funding. Since then, the risk of funds withdrawal or funds scarcity has applied overwhelmingly to uninsured funding, not to insured funding. True, a diseased bank today will frighten not only its own fully insured depositors, but also the depositors of healthier affiliates of the same BHC. A scary bank will frighten even the depositors of nearby banks, regardless of their health.

Yet it is still safe to say that fully insured depositors are a renewable resource that will continue to fund a bank, even one in crisis. Let us hope this stays true. Were public mistrust of FDIC integrity to increase, the implications for bank liquidity could be shattering, potentially impacting the national economy as bank lending is cut back. It is not enough to base our definition of bank obligations only upon uninsured funds-providers. The post-1980 definition must include the potential funding requirements arising from loan commitments, letters of credit and other off-balance-sheet products. These links to the marketplace may suddenly obligate more funding than the bank can attract quickly. Not only that, but in a high-tech "wired world" any breakdown of a high-volume transaction processing system—as at Bank of New York in November 1985—can obligate huge funding.

- What do we mean by "ability"? Faced with intrinsically unpredictable funding flows from uninsured providers, a bank will draw upon two types of liquidity sources: internal and external. By "internal sources," I mean the unencumbered near-cash assets that a bank can bring to bear as a liquidity reserve against its uninsured creditor exposure. Net funds sold, deposit placements, unpledged investments, and in recent years the sale and securitization of loans are examples of near-cash assets.

Note that "cash and due from banks (not at interest)" is not defined here as a near-cash asset. This asset category misleadingly occupies the upper left-hand corner of a bank's balance sheet. The trouble is that the three major subcategories of "cash and due"—Fed reserves, float, and vault cash—are in fact frozen assets that cannot, in a "going concern" bank, be used to pay down liabilities or acquire other assets.

External Sources

"External sources" of liquidity refers to the capacity of a bank to renew or expand external funding, that is, large-dollar borrowing power in one or more markets. For smaller banks, even those in good condition, this power is extremely limited because their market reach is so narrow. For large banks, borrowing capacity today is dependent upon demonstrable strength, in part upon an established name in financial markets, and in part upon the TBTF doctrine itself (one of whose maleficent side effects is to encourage funds-provider complacency).

The way to measure liquidity within a holding company is to diagnose the funding power of the cash-flow entities.

TBTF distorts both bank and funds-provider behavior. The huge 1985-88 build-up of Bank of New England's uninsured funding, for example, hardly meant a private-sector endorsement of the company's strategy. Instead, it merely reflected the indifference of institutions that correctly saw themselves (under TBTF) as risk-free.

On Creditworthiness

- Creditworthiness is the ultimate test of liquidity. We should never forget that borrowing power ultimately depends upon market perception of the creditworthiness of the entire institution. Thus other "CAMEL" factors such as sustainable earning power, adequately reserved asset quality, strong capital, and BHC strength are integral elements in the liquidity equation.

An "official" illustration of this point is the May 1985 policy of the Federal Reserve Board toward payments system risk control, i.e., "daylight overdrafts." Influenced by the Association of Reserve City Bankers and Robert Morris Associates, the FRB succinctly defined creditworthiness as the "ability to fund rapidly" in the event of a crisis resulting from settlement failure. In essence, liquidity is the ability to fund rapidly, and it requires general institutional creditworthiness. Because of this, no narrow set of ratios can reliably measure "liquidity," whether of a bank or a holding company.

Liquidity Entities

There are two dangerous blindspots that distort much of the professional analysis of banks today. One is to view a bank affiliate of a BHC as though it were a free-standing entity. This error is most commonly practiced by banks and broker firms whose risk exposure is directly to a bank. The other myopia is to concentrate upon the fully consolidated financials of a BHC, as though that were the reality. This error is most commonly practiced by stock analysts and certain credit rating companies.

Here are four ideas that can be useful in analyzing banks today:

- A bank member of a BHC, though committed to support its BHC, is at the same time protected from owner depredation by banking law and regulation; it must therefore be analyzed separately for soundness but always in the context of its BHC.
- A BHC parent (a narrow entity quite distinct from the fully consolidated BHC) depends upon the relatively thin cash flows it can develop from its subsidiaries to sustain debt service and dividends to parent investors; it must therefore be analyzed directly, but always in the context of the cash-flow power of its subsidiaries.
- The only "liquidity entities" (that is, cash-flow entities) within a BHC are the operating affiliate(s) and the parent; fully consolidated financials simply do not summarize a liquidity entity and, moreover, blur the pockets of strength/weakness that may exist within the BHC. As a result, consolidated statements, though useful, are insufficient as a basis for describing the creditworthiness or liquidity of a BHC.
- The proper way to measure liquidity within a BHC is to diagnose the funding power of each of the cash-flow entities, bank affiliates as well as the parent's capacity to maintain its own liquidity. Though difficult to undertake, it is not only feasible but constitutes the "state of the art" of bank/BHC analysis.

Liquidity Standards

Banking is now at an "action frontier," where only experience, expectation and judgment will lead to good decisions by bankers and funders alike. The trouble is that funds-provider fear, coupled with ignorance, could foster a nightmare liquidity environment, simply by rewriting the rules.

To put it another way, while liquidity can be easily defined in an article, who can anticipate the "decision rules" that uninsured funds-providers and other unsecured creditors will bring to bear (sometimes irrationally) on their banking relationships?

The fluid nature of liquidity standards, as described above, requires managements to be responsive to their uninsured funds-providers, especially if Congress puts large-dollar funds-providers somewhat at risk in the 1990s.

Faced with this funding uncertainty, bank managers should follow three steps: First, each bank/BHC must assure itself—and the board—that its "ability to meet obligations" (a concept that includes overall "creditworthiness") is adequate to a possible crisis environment. Second, the bank—management and board—should assure itself that its liquidity program (more broadly, its risk profile) looks good to the faceless army of remote credit analysts who potentially will recommend credit approvals or disapprovals. Third, if a discrepancy exists between a strong internal program and the way the data looks from outside, the bank (or BHC) should devise a credible communications program to show that the company is, in fact, creditworthy.

Reality vs. Appearance

Here are some examples of the many disparities between liquidity reality and appearance that can hurt the perceived credit standing of a perfectly sound bank.

1. "Near-cash assets" appear understated. When professional analysts try to summarize the unencumbered "temporary investments" of a bank, they like to see an appropriate fraction of those assets relative to "large-dollar" (i.e., mostly uninsured) funding. What if the "cover" is less than,

say, a comfortable minimum of 20%? The credit analyst may fail to see that (a) unpledged, long-dated investments are substantial; (b) loan cash flow is substantial; and (c) an institution's ability to sell loans or securitize them is well documented. Bank managers need to make credit analysts aware of such factors.

2. Large-dollar liabilities appear overstated. Not all uninsured funding comes from Tokyo, Frankfurt or Bahrain. For banks of $500 million to $2 billion in assets, most large-dollar funding is local, loyal and linked to the bank through client relationships. For such a bank, "core" is a word that better describes this funding than the word "volatile" (a favorite of regulators). If the ratio of volatile liabilities to earning assets looks high, it's the bank's job to explain the stability of the funding base.

Capital Ratio

3. Equity capital looks thin. There are several good reasons why a seemingly thin ratio of "capital to assets" can be quite benign (just as there are reasons why a strong capital ratio can turn out to be air). First, the bank may have an "equity credit" by virtue of a redundant loan loss allowance. Second, the bank's "risk-adjusted" assets (including off-balance-sheet volumes) may be a low fraction, say 60%, of total assets; as a result, true capital adequacy is 40% greater than the old-time ratio implies. Third, sustainable profitability may be high enough so that, after dividends, retained net income (i.e., your capital formation rate) is advancing more rapidly than asset growth. Fourth, a BHC may have a fully consolidated capital strength that compensates for the relative weakness of the bank's capital position. Fifth, there may be substantial unbooked gains on premises and other assets (even liabilities like core deposits!) that stand behind capital. Again, it's the bank's job to make these points.

Parent Debt Service

4. The parent company's financials show a cash-flow deficit. Since the payment of parent debt service and shareholder dividends depends upon rather narrow internal cash sources (dividends from affiliates, internal "tax" credits, etc.), it is not a good sign to seem to be in deficit. If deficits persist, parent borrowing power is curtailed. Yet from time to time, a deficit can be benign. A large bank affiliate of a BHC may halt its dividend to the parent to build capital or reserves. If this is a one- to two-year program, to be foreseeably succeeded by resumption of a moderate dividend, the parent's creditworthiness is unimpaired.

As you make these points to your board and to funds-providers, you can expect to encounter (at least from the latter) polite but cynical resistance. The trouble is that for every truthful story, there is at least one fake, whether because managers lost touch with reality, or because (more rarely) they actually lie. In the more perilous liquidity environment of the 1990s, the truth-tellers are going to have to work harder. **BAI**

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Senator **Dodd**. That's very helpful, and we'll have some questions for you in a few minutes, but let me move on to Mr. Blair.

John, maybe you would like to make some opening comments.

Senator **Kerry**. I just want to welcome Mr. Blair who was here this morning, and I knew he heard the testimony. He leads one of the really outstanding agencies in Massachusetts, the Massachusetts Industrial Finance Agency.

During the years of our maximum growth, the Massachusetts Industrial Finance Agency accounted for more than 50 percent of the industrial growth in our State, and unlike some of the IDB tax exempt efforts around the country, was devoid of those kinds of excesses that attracted attention to the program and have created the sunset.

So we welcome you and are delighted that you are here, and I look forward to your comments.

STATEMENT OF JOSEPH D. BLAIR, EXECUTIVE DIRECTOR, MASSACHUSETTS INDUSTRIAL FINANCE AGENCY

Mr. **Blair**. Thank you, Senator, and you, Senator Dodd.

I appreciate the opportunity to speak out on the problems of small businesses in obtaining credit, and I want to commend you especially in taking a leadership role in this issue because it's very difficult to find a smoking gun.

When we look at macroeconomic numbers, the problem just isn't there, or it's very difficult to discern because it's not the kind of problem that lends itself to description by macroeconomic data.

If you take case studies and the examiners want to look at the case study, you've got one of two kinds, either the company goes and is able to find a new banking relationship, in which case the examiners say there is it, the system works and there was no problem in the first place, or the company doesn't get a new banking relationship after being cut off and the response is that well, that was a company that deserved to fail in a Darwinian system.

So it is difficult to find that smoking gun, but the problem is very real.

I want to talk about why we care about the problem and why we think this problem is different from the historical kinds of credit crunches we've had caused by disintermediation and other kinds of factors, interest rates. I want to talk about why we think the problem is real, and then I want to speak briefly about the points that I think need to be addressed in order to correct the problem.

Why is this problem different from historical credit crunches or contractions or whatever we want to call them?

As Representative Morrison said earlier, this is not a top-down credit crunch problem. This is a bottom-up problem. This is a situation where individual bankers are frozen from making the loans that in normal circumstances, even under credit contractions circumstances, they would be making.

Why is that important? It's double important now because for a variety of reasons the New England economy is in a period of transition. We have to make transitions from defense related businesses to civilian related businesses. We are recovering from the downturns in certain computer companies and their related industries, and we are recovering from the overextended portfolios of some of the banks in the region.

So this is a time of transition for the New England economy, and it's exactly this kind of time when the banking system needs to come in and be flexible with its borrowers, and exactly the opposite is happening.

As you both have said, this is a problem of psychology. It's a problem where the bankers with historical relationships of 20 years or more are saying I am sorry, the numbers just don't look right, we just can't continue with you, the relationship side of the business has gone away. As I have said in the testimony, bankers have to have brains and heart. They can't simply look at files, as the examiners are asking them to do.

Why do we think this is a real problem? Well, as Senator Kerry knows, we conducted a survey of our 1,800 small companies that have borrowed through the agency, and nearly half of the responses that we got back said that they had had problems in their relationships with their banks.

Now this is significant to us because our companies are all by definition creditworthy companies; that is to say, either banks had bought their bonds in the past, or else banks have provided letters of credit when we sold their bonds. So these are creditworthy companies that are being denied credit, and many cases the credit was working capital that they were denied, the life blood of those companies. And in follow-up surveys with those companies, we have found that those problems remain even today even though that survey was conducted some months ago.

I have in my testimony described a couple of cases, and I want to draw just a couple of significant points about them.

In both of the companies, in the cases of the companies in the testimony where the banks had gone in and said I'm sorry, we are going to shut off your working capital line, you have to find a new bank in 90 days, in both of those cases when those events happened, banking relationships extending back 20 years or more, the examiners were at the banks at those times.

We have another example in here that related to the FDIC, and between the time when I wrote the testimony and today I am happy to report a little bit better news on it of a small provider of residential treatment services to mentally handicapped and autistic and other handicapped children. In this case this treatment center had a line of credit from a bank that the FDIC moved in to take over, and the FDIC was not saying anything about being able to grant or flexible in offering a new line of credit with a different bank. In other words, when the existing bank's loan portfolio was transferred, the FDIC would insist that this small school's working line of credit would go along with it.

What do those cases have in common? In my mind the key is there is a lack of flexibility in each of those cases. There were cases where the numbers went down and all the bankers were interested in were the numbers. In fact, in the case of the two companies that I referred to in the testimony, the companies actually made a turnaround. In one of the cases in fact, in the next few days the company will announce that they have signed on a new relationship with a British bank for letters of credit and working capital and other financial services that they need.

To me it's a real shame that the New England banks that were serving them couldn't keep that business.

Finally, what do I think we need to do to address the problem. The problem in my mind stems from three aspects of how the regulators are dealing with the bankers.

No. 1, virtually every banker that I have spoken with talks about the suddenness of the change. You've referred to it earlier today. It just created a sense of panic among the bankers, a sense that nothing they did could be right, and the best policy was just to freeze.

No. 2, they all complain about a lack of clear and understandable guidelines. You, Senator Kerry, were referring before, you were asking questions of this morning's panel about whether there were definable economic criteria for making decisions, and the fact is that the bankers don't understand what the black box contains, and for that reason they want to be safe, and there again credit is denied to smaller businesses.

And most important, with an exclusive focus on the quality of the files, on the ratios, on financial performance, there is no room for judgment calls, and somehow it seems to me the examiners have to be judged on the basis of the quality of financial performance of the sector they are dealing with, and no just whether they have cleaned up some files. That is, bankers are in business to take risk.

In summary, the important thing that I think has to emerge from the examination process is that there has to be room for a human side to banking.

With that, I will conclude, and thank you very much.

[The complete prepared statement of Joseph Blair follows:]

UNITED STATES SENATE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

Hearings on Availability of Credit

June 21, 1990

Statement of Joseph D. Blair
Executive Director
Massachusetts Industrial Finance Agency

Dear Mr. Chairman and Members of the Committee:

Thank you for this opportunity to present the concerns of small businesses on the availability of credit. I want to commend you for your leadership in pursuing this issue. The bankers and their regulators play a critical role in determining the long-term health of our region's economy. If they help businesses make the adjustments that lie ahead, the economy of the Northeast has the capacity to renew its strong growth. Without assistance from the banks, the recovery will not come.

My name is Joseph Blair. I am Executive Director of the Massachusetts Industrial Finance Agency. We issue bonds, make loans and provide financial guarantees for small businesses, non-profit institutions and public bodies in Massachusetts. Before joining the Agency, I was a vice president in public finance at The First Boston Corporation in New York.

I want to emphasize one theme today: the importance of the banking system in times of growth and change. We believe the current economy confronts a serious danger -- a loss of the flexibility it needs to make changes. An economy in transition needs a patient banking system. Bankers must be able to look at the long-term. In other words, bankers must have brains and hearts. They cannot make decisions based solely on what spreadsheets say about financial ratios and performance. Bankers must have the freedom to ask, "Can this manager turn the company around? Can the manager find new markets, improve service and cut expenses?"

In contrast, the examiners focus on the files. They ask, "How are the ratios changing? How recent are the appraisals?" The examiners take a static view, rather than understanding how economies and companies change and how the banking system can nurture those transitions.

The Northeastern states are now making several transitions at once:

- They are recovering from down-turns at companies in key sectors such as the computer industry;
- They are preparing for a shift from defense-related industries to civilian purposes; and
- They are reacting to the difficulties of banks that over-extended their real estate portfolios.

The New England economy has made several major adjustments in the past. When textiles and leather goods went into decline as job producers, new engines of growth such as high technology and financial services provided stimulus. During these past transitions, the banking system worked in patient partnership as companies changed and grew.

A major part of the current problem comes from the chilling effect of sudden and drastic changes in the regulatory environment for banks. Our Agency recently conducted a survey of the 1,800 companies that have borrowed through the Agency over the past 12 years. We did not attempt a scientific survey. We wanted to confirm the information we were getting in a steady stream of anecdotes about sharp restrictions in the availability of credit. The 230 responses we received convinced us that the problem was real and wide-spread. The problem reached beyond real estate developers and retail establishments to traditional manufacturing companies. It is important to note that bankers had judged virtually all of our companies creditworthy at some point in the recent past because they had either purchased their bonds or provided letters of credit when the companies borrowed. Nearly half of the respondents indicated some kind of problem with how the banks were treating their existing loans or new requests. One out of every four of these companies faced severe restrictions in the availability of working capital. We saw case after case of companies that encountered arbitrary and harsh treatment -- companies that were current on their debt service but were facing far tighter restrictions on their access to capital.

In recent follow-up interviews with companies that gave detailed responses to our first survey, we find that the problems continue for virtually all of the companies. A few have convinced other banks to look at their needs, but they know they will have to pay a price. Typical comments were: "We are just waiting for the other shoe to drop." "Banks are too busy getting files together to discuss any new business." "We worked with the same guys for 20 years, now we have to deal with new people who aren't interested in what we do." A majority of the comments reflected feelings of fear and uncertainty.

The Massachusetts Industrial Finance Agency has gained a reputation for finding new sources of capital to assist borrowers. We have introduced numerous international banks to the capital needs of small borrowers in the United States. However, no external source of capital will completely substitute for the local banks. Small companies need their bankers -- for working capital, for a full range of loans and for advice. We may succeed in lowering the costs of borrowing or introducing new sources of funds, but the local banks play a critical role.

As we investigated the reasons for the difficulties facing our companies, we determined that no single factor deserved all of the blame: not a down-turn in the economy, not an over-reaction from bankers and not over-zealous regulators. Rather, all three factors must share the blame.

To illustrate the importance of flexibility with small companies and non-profit institutions in a time of transition, I want to discuss three specific cases. A frustrating aspect of this problem is that the companies involved rarely want to talk about their problems on the record. They correctly fear that any bad news might jeopardize efforts to establish new banking relationships and lead to a panic among their vendors and employees.

CASE #1

The FDIC recently moved in to take over a lending institution in central Massachusetts. One of the victims was a small non-profit residential school for 175 children with multiple disabilities including mental retardation, autism, physical handicaps and severe behavior disorders. This state-funded agency has never missed a debt payment and relies on a line of credit to provide a buffer against timing differences in cash flow. While it waits for state payments, the school must pay staff, buy food and pay for treatment for the children.

When the FDIC seized the bank, the school's accounts were frozen, thereby cutting off the school's life line — its line of credit. An FDIC representative described his mission in these words: "We want out of this transaction entirely and in one fell swoop, not two or three. We must liquidate as soon as possible." The FDIC is unwilling to provide indemnification to a new trustee. The FDIC could insist that when the loan accounts move to a new bank, the school's line of credit must go with them. However, it has shown no willingness to extend that kind of flexibility to the school. The school must fend for itself.

CASE #2

A food products company in northeast Massachusetts heard from its bank of over 20 years that the company could not obtain additional short-term credit it needed and that the company had to pay off its outstanding loans -- totaling $14 million -- in 90 days.

Although the $150 million company had had a difficult year, it was current on its obligations. In the past, the bank had continued to work with the company in slow periods. This time, the bank cited a need to improve its asset position and told the company that it did not fit the profile of borrowers it wanted even though the company had turned around and returned to profitability. The company is currently looking for new banking relationships.

CASE #3

A $19 million packaging company, employing 275 people, recently faced a severe reduction in its working capital line. The company has been a client of the bank for over 30 years and is current on all of its obligations.

The bank did not renew the line of credit in April, 1990 because of a one-time technical default. The company suffered a loss for one quarter but for the next three quarters the company operated with modest profits. The bank gave the company an extension of its line of credit at a reduced level while the company searches for a new banking relationship.

The common thread that runs through these cases is the loss of flexibility. With regulators looking over their shoulders, the bankers have no desire to take even prudent risks to help businesses through hard times.

Does this mean that examiners should not enforce the rules? On the contrary, we would all agree that the regulators perform a necessary and valuable function in helping to maintain the soundness of the banking system. I submit that good rules may have bad effects if the enforcement seems arbitrary or unreasonable. I will give three examples:

- Examiners say that they do not make economic policy. Whenever an examiner challenges a banker's assumptions about capitalization rates or discount rates or lease-up of development projects, the regulator is making economic policy. Faced with uncertainty about economic assumptions, the bankers freeze.

- The regulators indicate that they focus almost exclusively on real estate loans. When the regulators target real estate, they include many loans to manufacturing companies and other types of enterprises. Most small companies must pledge buildings and other fixed assets as collateral when they obtain capital.

- The examiners defend their sudden change in enforcement by expressing fears about a repeat of the savings and loan crisis. With few charges of malfeasance at New England banks, it is difficult to understand this worry. We see no reason to doubt that the banks would have responded on their own to a more difficult lending environment. The banks now find it hard to ignore pressure from regulators and make new loans. Our companies report that their banks now have one concern -- how to get their files in perfect order.

In conclusion, the economy of the Northeast needs the support of the banking system in order to manage the transitions ahead. We believe the examiners have forced the flexibility out of the banking system. If we must have changes in regulation and enforcement, we urge that the regulators take a gradual approach. If the examiners reject old assumptions and adopt new ones, we ask that they make their reasons clear. If the banks must observe new rules, we hope the examiners will give them room to make judgment calls about the long-term prospects of companies in transition.

UNITED STATES HOUSE OF REPRESENTATIVES

COMMITTEE ON SMALL BUSINESS

Hearings on Availability of Credit
to
Small Business

April 25, 1990

Statement of Joseph D. Blair
Executive Director
Massachusetts Industrial Finance Agency

Dear Mr. Chairman and Members of the Committee:

I want to thank you for this opportunity to discuss the concerns of small businesses on the availability of credit. My name is Joseph Blair. I am Executive Director of the Massachusetts Industrial Finance Agency. We issue bonds on behalf of small businesses as well as non-profit and governmental institutions of the Commonwealth of Massachusetts. Our Agency is independent in that we receive no support from the Commonwealth of Massachusetts nor do our bonds carry any Commonwealth guarantees. We serve as a catalyst for economic development by finding banks, bond insurers and investors for projects that create jobs. In the Agency's twelve years of existence we have assisted in creating or retaining almost 80,000 jobs through more than $5.5 billion of financing for approximately 2400 projects. Before joining the Agency, I was a vice president at a major investment banking firm, where I advised states and cities on their financing needs and economic development. My comments today reflect a deep concern about more than just the availability of credit to Massachusetts businesses. I believe this disease of tight credit has the potential to spread beyond the Northeast into other parts of the country and that it could have a harmful effect on the economic health of our country in the 1990s.

Over the past several months, our Agency has heard many anecdotes about the problems that small businesses have had with their banks. Bankers will say that customers always complain about their services but even many of the bankers agree that they are now much tougher on small businesses. We decided to conduct a survey of our borrowers to determine whether the problem went beyond the handful of stories that had come to our attention. Taken together, the responses make a dramatic statement. I am here today not to fix blame but to call attention to a problem.

We draw three general conclusions from our survey results and from our discussions with bankers, accountants and others who serve small businesses in the Northeast. We have learned of other surveys that support these conclusions.

- The problem is real.
- The problem is wide-spread.
- The problem is too complex and potentially too severe to have a single cause, whether the explanation is slowness in certain sectors of the economy, changes in the behavior of bankers, or an excess of zeal from regulators.

THE PROBLEM IS REAL - SURVEY RESULTS

Our Agency mailed a one-page survey to approximately 1800 small businesses that have borrowed through us. To date we have analyzed 228 responses and of that number, 106 companies indicated significant problems with the availability of credit within the past six months. I want to underline the fact that this was not a scientific survey: we did not do a random sample and we designed our questions to draw out information on the kinds of difficulties the companies were having. We assumed that companies with problems had a much greater incentive to respond to the survey. Still, we never expected to get such a strong expression of worry. One key point: Our borrowers have earned the right to be called "credit-worthy" because virtually all of our bonds were purchased by banks or carried bank letters of credit. In other words, at some point in the recent past, bankers evaluated these companies and concluded they deserved to get loans or letters of credit. Our companies are not start-ups, nor are they the products of highly leveraged transactions.

1. Banks have capped or suspended existing lines of credit.

Forty-eight of the 228 respondents indicated that their banks have either capped or suspended lines of credit. In several cases, the companies indicated that banks had become much tougher in granting waivers of covenants that they had previously given. In other cases, the banks asked for significantly stronger guarantees or greater commitments of capital to secure the lines. Working capital is the life-blood of a business. Without it, these companies cannot operate, much less expand.

2. Banks have renegotiated the terms of lines of credit.

Thirty-seven of the companies indicated that banks have switched their revolving lines to fixed lines or have otherwise changed the terms of their working capital loans in a manner that cut the available cash for operating uses. Again, a sudden restriction on the amount of available cash can inflict severe damage on a business. Combining the "yes" answers to questions 1 and 2 (and accounting for cases where companies answered yes to both), we discovered that one of every four businesses faced new limits on the availability of working capital.

3. In a few cases, banks reclassified loans without good reason.

Eighteen of the 228 companies indicated that their banks had changed the classification of their loans without justification. While this number is not insignificant, we take this modest response as partial evidence that the problem does not stem from arbitrary and capricious action on the part of the bankers. Rather, the companies may be feeling the effects of tougher enforcement.

4. Lenders have reappraised the value of the collateral for loans.

Forty-three of the 228 borrowers indicated that banks had reappraised the value of collateral, and in many cases, asked for additional security for existing loans.

5. Lenders have changed covenants or have changed the way they interpret and enforce existing covenants.

Thirty-seven of the companies indicated that their banks had increased the strength of covenants or had grown much tougher in their enforcement.

6. A significant number of businesses that had once been credit-worthy are now unable to obtain capital.

Of the 228 companies, 85 indicated that they had applied for additional capital in the last six months. Of that number, 29 indicated that their requests were turned down. Of the remaining number, we can presume that many applications are still outstanding (please see the next point on the unusual delays that companies are confronting).

7. Borrowers are experiencing unusual delays in the process of applying for a loan.

Forty-one of the respondents indicated that their banks were much more cautious, were imposing more stringent rules and in some cases, giving the "run-around" to borrowers with flawless credit histories.

We found the stories of these companies much more alarming than the numbers from the survey. We heard from companies that were long-time bank customers, were current on their obligations and yet had their loans accelerated. We learned of the desperation of companies that were suddenly without the financial resources they always had. We saw expressions of fear because the company's bankers were no longer the partners they had once been -- fear that the flexibility had disappeared from the financial system and that one false step could lead to ruin.

THE PROBLEM IS WIDE-SPREAD

The complaints came from a wide range of borrowers and pointed to a broad number of banks. When we compared the companies that cited no problems to those who did, we discovered that they are distributed roughly the same across major industries. Although we did not ask the companies to name their banks, we learned that the problem extends beyond the one or two banks that have received the most publicity in recent months. We found that slightly more of the smaller companies cited problems, but the larger companies cited problems too.

THE PROBLEM DOES NOT HAVE A SINGLE CAUSE

Some observers have pointed to a single villain -- whether the economy, the bankers or the examiners. I believe we should look at all three sources. We cannot control forces like the slow growth of certain sectors of the economy. Should we not focus on the causes that are within the control of policy makers? If the problems with bankers have a psychological basis, and the bankers are acting in fear of the regulators, then can we turn away some of those worries through less arbitrary and punitive bank regulations and examination practices?

I would submit that we should ask ourselves what we can do to break this crisis of psychology.

1. The Economy

Almost everyone would agree that certain sectors of the Massachusetts economy have experienced a moderate decline in recent months. In particular the construction, retail and computer industries have each experienced slowdowns of varying magnitudes. However, I believe that it is simply wrong to assume that the Massachusetts economy will undergo a serious decline over the next two years. In arriving at my conclusions, I am relying on the opinions of such experts as Richard F. Syron, president of the Federal Reserve Bank of Boston. Our Agency also continues to see a strong pace of applications for expansion financing. The bankers tell us that the examiners are taking a much more pessimistic view of the state's economic future.

I believe we will see only a moderate decline even in the near term for three reasons: 1.) Massachusetts has a relatively stable economy. Our manufacturing sector (representing approximately 20% of employment) sells to the entire nation. Assuming the national economy continues to grow at a steady pace, our state's manufacturing and service sectors should remain strong. 2.) Massachusetts has the benefit of a diverse economy. When one industry slows down, other industries can take up the slack and often add employment. 3.) Most important, the Massachusetts economy has demonstrated that it is robust. When the textile and leather goods industries declined in the 1950s, a number of manufacturing industries grew and spurred an increase in employment. As the national economy declined in the late 1970's and early 1980's, the computer industry boomed in Massachusetts. Now we see a number of industries such as biotechnology, medical instruments and various service industries that could move to the fore and create new jobs. In sum, we are not in a steep decline. Perhaps the economy is not booming as it was a few months ago, but we see underlying strength.

2. The Bankers

Many bankers say privately and even publicly that they made loans during the boom years which they would not make now. They show no evidence of panic however, at least, not in reaction to the prospects for the economy. They do express fears about regulatory matters.

In particular the banks are under pressure to increase their capital ratios. With the hits they have been taking to their balance sheets, the pressure on capital requirements has grown even greater. Even without overzealous examiners, the bankers could grow more conservative in their lending practices. If a bank wants to improve its capital ratios and cannot raise equity capital, it must reduce assets. That means the bank will make fewer loans.

Still, the bankers themselves say privately that they have bigger problems than the requirement to maintain adequate capital ratios. They point in particular to the damage to their reserves and net interest income because of the requirements of the examiners.

3. The Examiners

In preparation for this testimony, I spoke with senior bankers from several New England banks. They cited a number of specific points where the regulators seem to be making unfair judgments. More troubling, every one of these officials indicated that the examiners set new rules and expressed very pessimistic views of the state's economy. Their comments were consistent on those points.

The bankers gave several examples of these unreasonable standards:

- Excessively high capitalization rates in the range of 12% to 14% instead of the usual 9% to 10%.

Effect: Future cash flows have far less value. Even manufacturing projects that involve the purchase of real estate assets will carry a far lower value and will not show high enough returns to merit a loan.

- Drastic discounts on appraisals, particularly if the appraisals are more than a year old or involve any raw land.

Effect: The banks have to take hits to their reserves and in some cases have to classify performing loans as non-performing.

- Unreasonably pessimistic assumptions about lease-up of real estate assets.

Effect: Many projects that would show acceptable returns under more normal conditions will fail to get financing. Existing loans may fall into the non-performing category even if the borrowers are current.

- Disallowing the recognition of income on non-performing loans.

Effect: By keeping banks from recognizing the interest income on loans that are current, the examiners are artificially driving income down and thereby lowering the banks' equity. The result is that the banks will make fewer loans.

In sum, the current tight credit conditions in the Northeast come from at least three factors -- the economy, the bankers and the examiners. I have expressed concerns about the balance and judgment the examiners are using in these difficult times. I recognize that the regulators have a very tough job to do. However, small businesses rely on financial institutions not just when times are good but when times are bad too. Small businesses need flexibility from the financial sector now. Other sources of capital have grown even more important. I believe strongly in the need for the type of assistance available through SBA loan programs and tax-exempt Industrial Development Bonds. I hope Congress extends and strengthens both of those sources of assistance to small businesses particularly in this difficult period. Still, small businesses need their bankers. When bad times come, we cannot just shut out the lights.

Senator DODD. Thank you very much, Mr. Blair, and we thank all of you for your testimony.

Let me ask all four of you sort of a general question, and we can go on, and Senator John Kerry eloquently this morning talked about the problems in Massachusetts, and Congressman Morrison, that I think all of you heard here this afternoon, gave a very concise statement about the extent of the problem we see in Connecticut. And we are hearing from people like Mr. Maizlish who talks about this being nationwide, and you, Mr. Shivers in the southwestern part of the country.

The frustration that I feel as a member of this panel is we can I think identify with the frustration of our constituents who are expressing this, but I think at this point here they are not going to say well that's all well and good, Senator, but what are you going to do about it, and we're, or at least I feel a little constrained. We don't want to, on the one hand, obviously tell examiners not to do their business, their job. They've got a job to do, and it may be, in fact I'm certain there are many instances where frankly a mere signature on a loan application qualified for satisfactory information for a loan, and obviously none of us at this table, regardless of where we are from in the country, want to be a part of any effort to suggest that bank examiners ought not to be doing their job and doing it well and insisting upon good practices at lending institutions.

Simultaneously, we cannot tolerate this situation which regrettably they failed to perceive or see as being as serious as it is.

I wonder if you might just take a minute, each of you, and offer some suggestions as to what you think we ought to be doing next here. We can hold hearings, we can have meetings at some point, but it seems to me we are still having a difficult time getting our message across about how widespread and serious this problem is, even if it's only a perception problem.

I buy the notion this is a real credit crunch, but even if you don't buy that, you at least have to buy the notion that there is a serious perception of a credit crunch, and in our business perceptions can be more devastating in some cases than reality. So the notion, even getting beyond that particular point, seems to be important.

I wonder if we may start with you, Mr. Blair. What would you recommend that Senator Kerry or Senator Dodd and other members of this Banking Committee do at this juncture?

Mr. BLAIR. Well, I think you're right that it is real, but more important it's a problem of perception, and it's a problem of psychology, and how do you break the psychology is really the question.

I think it helps to have Mr. Clarke meet with bankers, as he has been doing, and try to cajole them into being more flexible, but the reality is that it's the day-by-day interaction between the banker and the examiner that really determines how the banker is going to behave.

I think somehow the examiner has to be measured on a different basis, not simply whether he is enforcing the right rules but how he is enforcing the rules. It's a much more difficult matter to measure, but I have to believe that differences in enforcement are probably much more important than the quality of the records in many ways, and there has to be that room for judgment.

So to me it gets down to that individual relationship, banker to examiner, and there just has to be a different system of management within the examination system, and I think also, as you were saying earlier today, we need more information.

I think your questions this morning were very perceptive. What is the basis for these decisions? I mean a project that had a capitalization rate, as Mr. Maizlish pointed out, of 8 or 9 some years ago, and now has a capitalization of 14 or more means that the numbers just don't work and the project doesn't have the value that it used to have. What is the basis for that decision, and what is the assumption about the New England economy that allows you to make such a drastic decision about where the economy is headed.

So eliciting more of that information I think would be very helpful.

Senator DODD. I might just point out, by the way, that we tried very hard to get bankers to be witnesses today. Now that ought to tell you something. I mean bankers are not a shy crowd when it comes to testifying before Congress on things. Yet, the reality is, and I'll say this publicly, we had a dreadful time, a dreadful time to get any member of the banking community to appear publicly at a hearing like this to talk about this issue. Now if that isn't a piece of evidence worth something, I don't know what is, but it's certainly reflective of the kind of problem we're facing when bankers refuse to appear publicly to talk about a problem that is reflected in surveys and information across the country.

I didn't mean to interrupt. I'll give you a chance to respond to this in any order you see fit.

Mr. Cates, do you want to go first.

Mr. CATES. You have asked for ideas on what the Senate should——

Senator DODD. If there is anything. Maybe we're doing what we should be doing at this point and that's enough.

Mr. CATES. I will make a suggestion in the context of basically there is not much you can do, but that suggestion is to urge the regulators, and particularly the OCC, which has made the sharpest adjustment in its policies, to be fair and encouraging with bankers.

The anecdotes that I have heard, and this doesn't constitute proof, but it does constitute a lot of anecdotal evidence because I do talk with lots of bankers, confirms the opinions expressed elsewhere at this table, that the examiners have gotten very tough, and I hear from many bankers that there seems to be almost a competition in severity of how tough can this examiner be compared to some other examiner. And I know that Mr. Clarke doesn't intend that to happen, but within the bureaucratic process it does happen, and I think you can do a great deal to try to soften that.

But bankers have several outside devils, and bank examiners are only one of the devils. Stockholders and institutional shareholders put tremendous pressure on banks for a certain kind of performance, and credit policy is one part of their set of concerns. They don't like a high-risk credit policy. Rating agencies are another devil of bankers, Moody's and Standard and Poors and others are urging bankers to get liquid and well capitalized, and that means to cut back on their lending.

If you have tracked the behavior of bank credit ratings from S&P and Moody's since 1982, in virtually every year there have been two to one downgrades over upgrades while the foreign banks enjoy very high credit ratings.

Senator **Dodd**. I said no bankers, and of course, Mr. Shivers, you're an exception to my statement. We thank you immensely for coming forward. I know you know what I'm saying here, and I appreciate your willingness.

Part of the problem is reflected in the fact that we had a difficult time getting bankers to come, and Mr. Shivers obviously is an exception to that, and we deeply appreciate your willingness to be here today.

Mr. **Shivers**. Well, I've never been bashful about speaking my words, Senator.

You expressed concern this morning, you and your colleague, Senator Kerry, about what is going on in your State, and my advice to you is from what we have been experiencing in Texas, batten down the hatches, the tornado is just getting ready to start.

My suggestion would be, and Bob Clarke has been a personal friend of mine for many years and so has Mr. Seidman. What Mr. Clarke said this morning about his examiners, what he said, he believes what he said, but during the bureaucratic rumblings of the OCC, by the time it gets down to the field examiners, they don't get the word about being fair.

Their attitude, whether it's OCC, the FDIC, the Fed or the Texas State Banking Department, they are all saying it's the field examiners we have to deal with, and many of them are very young and a lot of them are inexperienced and they've got a lot of authority and a lot of it has gone to their heads, and they take the attitude it seems like if I criticize everything I haven't missed anything so nobody can criticize me for not doing my job.

They have taken the rules and have started enforcing them extremely stringently. There is not really a system of due process in there like there is if you and I have an argument with IRS and there are several appeal processes. There really is no due process. We can go talk to our regional administrator, whether it's a national bank, or to the FDIC regional office, but you're sticking your neck way out on a block. The next exam those examiners may get even with you, and they will threaten you that way.

Many of the examiners from your part of the country have already been to Texas to be trained.

Senator **Dodd**. A lot of our New England folks feel like, they say they are all from the Southwest.

Mr. **Shivers**. Well, they are sending those up there now.

Senator **Dodd**. They said all the guys that were examiners in Texas were all from New England.

Mr. **Shivers**. They were sending all your examiners down to our area to get trained. As one bunch said back in the oil crunch, they came in and in 5 minutes threatened me with a cease and desist order that I was lying to them and there were all sort of penalties when they said where is your energy portfolio, and I said I don't have one. They said don't lie to me, you're a Texas bank and you've got to have an energy portfolio. And I said I'm a small

Texas bank and I don't have any energy loans, and they just got madder than a wet hen about it.

Another bunch from the New York and New Jersey area came in, they did not like being sent down to Texas for an 8 week stint, and I was the first bank they came to. They came in with the attitude, they said all Texas banks are broke and we are here to prove it. And if you don't think that wasn't fun for the next 2 weeks.

The field examiners have overreacted badly. Their examining criteria have gotten extremely stringent. Other than the problem that I mentioned with the workout banks, our major problems are coming from a lot of businesses with good performing loans and have always performed, and they have been thrown over in a junk bank because NCNB or somebody said we don't want to do any business with the manufacturing area, agricultural area, dairy lending or many other areas. They want to issue credit cards, buy commercial automobile paper and loan to IBM and AT&T.

I've got a loan that is classified for a shopping center, and the reason it's classified is because it lacked $200 a month of cash flow to meet its debt needs. It didn't make any difference whether the borrower had the personal liability to service that or not. It was classified for that reason. And they are doing that. They are doing that on home loans.

A banker friend of mine told me that he just got through an examination, and this was an OCC exam. The examiner wanted him to write down a home loan on somebody's home that they had been making monthly payments on for several years and never missed or were a day late because a little examiner said I don't believe the value of that house. My grandmother lives over in that area of town and her house is not worth that much.

We all know in this room that housing values vary house by house and street by street and in the neighborhood, and those are some of the ludicrous statements that we have to put up with as bankers on a day-to-day basis with examining forces.

Another problem in Texas is all the real estate held by the FDIC and the RTC. They are not dumping it. They are not doing anything with it. If you want to buy a piece of it, good luck. Eleven months from now you may get an answer, well, we'll think about it. They want cash, cash, cash.

And I would submit to you that you've already got the mechanism in place with the Farmers Home Administration, the FHA, VA and home loan finance systems of various types. You've got a financing arrangement that may finance these properties. Package them up, just like you do home loans now that has been going on for years. The taxpayers ultimately get a higher recovery on those assets with a financing arrangement and get a higher price for them and ultimately recover and lower the cost to the Government.

Senator DODD. All right, thank you.

Mr. Maizlish, any suggestions or comments quickly?

Mr. MAIZLISH. Well, I was absolutely shocked that there was a banker on this panel. I was fully convinced that there would not be, and I told my staff that there was no way that there would be a banker on this panel because they are just not going to come forward.

I give Mr. Shivers credit for coming here and believe me, I have talked to a number of bankers. I have talked to at least 50 bankers over the last month regarding this problem because I knew I was going to come here and testify, and each of them said the same thing, please don't mention my name, and obviously I'm not going to because if I did I probably couldn't get a loan from them again.

I think bankers for years have been using regulators as problems or reasons to turn down loans whether it was fact or fiction, but now it is really fact.

I heard Mr. Clarke, this morning, and I'm sure he is a very fine person and he is trying to do an excellent job, but I don't think he is informed of what is really going on in this field.

I know one time I had a problem in my Denver office, and I decided I had better go out there and see what the heck is going on, and I talked to the boss and I listened to him for a while, and then I decided, hey, he is telling me exactly what I want to hear, and I ended up going to the second and third and fourth levels.

And I think maybe somebody ought to do that in his department and see what really is going on and get the real facts of what is going on. These bankers are frightened to death of regulators. I have never seen a situation like this before in my life.

The truth is known now that I'm also chairman of the board of a small bank, and I can tell you, I personally am very frightened of regulators, and not because we have done anything wrong. I think our bank is in excellent condition. I really do. But I am very concerned with the way they walk in because they have the power to do whatever they want.

One banker told me, he said, Irv, I'm got a CAMEL one rating and, you know, that's pretty good. He says, but the reason is I can't make any loans. He says I don't have any bad loans. The regulators are looking at me, and he said, well, here is the loan I want to make. I wouldn't make that loan, and I wouldn't make this loan. He says, I'm not servicing the community.

This is the problem that we've got to everybody out in the field and really see what is going on. There has got to be a way that we can show Mr. Clarke that these regulators are causing problems.

Senator **Dodd**. Well, in fairness to Bob Clarke, he did, at least in my case anyway, he spent a good part of a day in Connecticut and met with the borrowers and privately with the lenders. In fact, we set it up specifically so it was not a public meeting with the lenders, and I gather, and I was not allowed to be at the meeting, and didn't want to be at the meeting, but I gathered that there were specific cases shared and, by the way, none of his staff was there really, but they dealt directly with him so he could hear directly. He said this morning that he intends to follow up on some of those specific things.

Mr. **Maizlish**. Perfect.

Senator **Dodd**. So we thought creating that kind of an environment might help a little bit to give him a chance to become familiar with it.

Senator Garn.

Senator **Garn**. Thank you, Mr. Chairman.

In all we have discussed today there is one aspect that nobody has dared mention, but I will, and that is the role of Congress in this, and I'm not going to take the time to drag out speeches over the last 2 or 3 years about these lousy regulators and examiners who haven't been doing their job.

It's not unusual for Congressmen and Senators to want to have it both ways. We went through the period when we were blasting regulators for not being tough enough and now we can blast them all for being too tough, and I don't mean to minimize the problem, and I'm certainly not referring to anybody on this committee, because there is a problem out there that we all know, and we need to try and solve it, and my opening statement was to try and achieve some balance so that we didn't get back to where we were, but on the other hand, we weren't denying legitimate good loans to sound businesses.

But I just can't fail to let this hearing go by to not mention some of the demagoguery that has gone on and the meetings that I have been to over the last couple of years. So part of the problem lies here in regulators that are scared to death of being criticized for not being tough enough because they have listened to all those speeches from the Congress of the United States during the last 2 or 3 years, and some of them were really tough, tough speeches, most of them primarily emanating from the other body.

Let me get to Mr. Shivers' statement, and I would like to follow up even more. You indicated the superfund liability was certainly reducing credit availability. It certainly has been my experience that even when lenders have been doing very careful due diligence on otherwise very sound loans, they have just felt compelled to walk away from those lending opportunities because they are afraid, as you mentioned, that there might be some environmental problem, and I won't repeat the example I used this morning myself, but I would appreciate it, Mr. Shivers, if you would repeat the example you gave me as we were talking before the hearing started.

I would like this in the committee record and my colleagues to hear how ridiculously this has been carried forth in some respects.

Mr. SHIVERS. This was told to me, Senator, 2 years ago by a banker friend of mine that is retired now back in Texas City. It came as a complete surprise to me that the EPA named his bank in an action over a piece of land, and when they checked the deed history of the land and the old records of the bank, the bank way before his time had foreclosed on this piece of land in 1947. It was on the intercoastal canal. And as near as they could tell from newspaper clippings of the time of the canal, there was nothing but salt marsh there, just grass. And in the intervening time, and they owned it for a 3-months' period and sold it, and in the intervening period, no telling how many owners they had and all sorts of developments and businesses were in there.

Well, the EPA, that was the only business they could find that ever touched that piece of land that still was in existence so all they could fine was the bank, and they wanted the bank to pay some ungodly amount of money to clean it up. And he had been fighting that when he told me about it for about a year's period of time. He has since retired, and I do not know what the final outcome was.

But that just shows how silly it can be and how far back it can go.

But I'm very leery myself. Somebody comes in for a loan for a dry cleaners or a filling station, and any business that handles any type of chemicals, and you've got the same problem with dairy loans now. Some of the State Water Quality Boards are complaining about the affluent that is running off the land of the dairies. That is also becoming a concern of some members.

Senator GARN. Well, I appreciate your repeating that because when you look at it, 41 years or so since they had owned it for 3 months, and then to be asked by EPA to clean it up. That is the most extreme I've heard in terms of timeframe, but beyond the general situation we've been discussing, you did it very well. You talked about in specific industries, and that is very generally true that where anybody is dealing with chemicals, farmers, and that type of situation, that it's really creating a very definite credit crunch in those specific type of business areas, in addition to whatever general credit crunch there may be.

That's why I introduced my bill. You know, as you sit here over the years, there are issues that come up that you can understand the other side of the issue, even though you don't agree.

This is one that I cannot even comprehend on the basis of fairness, that you go after people that had absolutely no culpability and nothing to do with the problem years and years later. I don't understand how we as a Congress allow a Federal Government agency to do that. Even though I don't want to be misunderstood, I'm certainly not in favor of letting a superfund site sit there and continue to pollute. The issue I make is that the responsibility is of someone who had nothing to do with it. It seems to me if you can't get the person who caused the pollution, then it ought to be the responsibility of EPA and the superfund money that we appropriate rather than trying to pin it on some innocent individual or company that literally had nothing whatsoever to do with it.

Now my bill is very careful about doing that. If some bank is actually on the piece, not just a loan, but equity position in that business, and polluting took place during that period of time, that's a different story.

Mr. SHIVERS. Senator Garn, banks are not allowed to have equity positions at least in Texas.

Senator GARN. Well, I can't remember exactly how——

Mr. SHIVERS. S&L's were able to.

Senator GARN. You are correct, but I can't remember exactly how we worded it, but nevertheless the point I wish to make is if the bank or the S&L did have something to do with it, that's a different story. What we want to accomplish is to not have the innocent lending institution involved because it not only has a chilling effect on lending but, as I mentioned earlier today, it does have a very definite effect on RTC and the ability of the funds that we are appropriating, $50 billion so far, and how that money is used and the taxpayers' ability to pay it back.

So I appreciate your mentioning that in your testimony, and the reason that I have so belabored it is that I am trying to make sure that there are more cosponsors, Mr. Chairman, from the committee, as they have heard this illuminating testimony on the value of that particular bill.

Mr. SHIVERS. Well, I can certainly tell you that you have a 100-percent backing of all the bankers in the country and all other lenders because it is something that is very frightening to all of us, and especially in some of the recent court cases.

Senator GARN. Well, I will make sure the remainder of the committee hears the testimony from both this morning and yours this afternoon and see if we can push that bill along.

Mr. MAIZLISH. You know, Senator, the shopping center industry has supported your request for that bill.

Senator GARN. Thank you, Mr. Chairman.

Senator DODD. Well, thank you, Senator Garn.

I would join with you in your opening remarks about demagoguery. That is not something unique to this issue.

Senator GARN. No. [Laughter.]

Senator DODD. Nor is it unique in our time. In fact, there may be less of it today than at other periods in our history, but it is the balance I guess that we are trying to achieve here, and certainly laxity is the sin of omission or the sin of commission. It's still sin in a sense. The sin of omission in one case or the sin of commission in this one is what we are trying to resolve.

But, anyway, let me stop there and turn to my colleague, Senator Kerry.

Senator KERRY. Thank you, Mr. Chairman.

I'm just going to be very brief. It's interesting listening to all of your testimony about the realities of what you're dealing with here because there is obviously less press and less focus in a lot of the groups involved in pressing to make things happen and the morning interest has waned into the afternoon, and some of those folks who are the key players who were the ones here, you almost wish we had a round table and an interaction so that we could get them responding to you a little bit.

This morning Chairman Greenspan responded to my question about the bond rating and the spread in the quality widening, and I talked about the triple A's and the AA and so forth.

Mr. Blair, you were here and you heard that this morning. Do you agree with his assessment on that? He said it wasn't serious.

Mr. BLAIR. Well, I certainly disagree with the point that it's not serious, and the reason why is I don't agree with the conclusion that he is drawing from the data. It's not that I'm disputing his data.

And here, if I could, I'm putting on my hat as a former investment banker. I worked at the First Boston Corp. in New York as a vice president there for a number of years before joining the Massachusetts Industrial Finance Agency, and I think what we miss in looking at the macroeconomic numbers is that the triple A and the triple B spread just doesn't, it misses such a large part of the population, all the small businesses out there that borrow from Mr. Shivers and other bankers every day.

I mean we don't see very many investment grade companies. They just don't go out for ratings. And in fact you could almost in a perverse kind of way argue that maybe this spread would go down, and the reason why is there are really three levels of borrowers now that we see in this credit crunch.

There is the blue chip company, not the real triple A company, but the blue chip small company that doesn't have a rating, but his is a valuable company, and the bankers will kill to keep that client. They want to keep that client, and they will do anything they can to make favorable loans. So for that client the interest rates are at least going to stay even and maybe even go down.

Then you've got a middle tier, and the question is whether the middle tier are going to get any financing at all. It's isn't a question of whether it's going to be higher or lower interest rates. The point we're concerned about is whether they get any financing.

And, finally, you have the cases that are what I'll impolitely call the basket cases, the cases that just aren't going to get any financing under any circumstances, and the problem we have in talking about this whole issue is that the only people who are really willing to speak out are either the great credits who are going to get financing eventually somehow, or else the really weak credits that just don't have anything to lose. They are going to go bankrupt or they are going to go out of business anyway.

But the voice no one is hearing is that middle tier, and when you look at a triple A to a triple B spread, it just misses that whole population that can't get access to financing now.

Senator **Kerry**. Now each of you heard this morning as statements were made in response to our questions, it's really the changes in the economy, and these are changed circumstances. Three years ago we had a better sense of your ability to pay. Three years ago there seemed to be an upward trend. Today suddenly it's down, and therefore we have a different assessment process and so forth.

Now do you agree that things have changed, and it's sort of which comes first, the chicken or the egg, that things have changed so dramatically that they are justified in making this decision that it's only a contraction, or are each of you asserting that notwithstanding legitimate changes in the economy, it is not just a contraction, it is in fact a change in policy, a change in attitude, a confusion in the application of the rules, et cetera.

Just a fairly short answer from each of you.

Mr. Maizlish.

Mr. **Maizlish**. I think it's a cause and effect in my industry. I think the cause was the 1986 tax law, and we are just feeling the effect right now. Absolutely it has taken all the risk out of doing business.

You know, the United States was built on risk and everybody that is involved in the United States is a risk-taker. To take a risk now in the real estate business or almost in any business, you get no reward. So why do it. And I think as an end result a lot of things that were going to be done are no longer being done and, as the end result, things are slowing down.

Show me one industry that is really flourishing in the United States. There really aren't any. I mean maybe the lawyers are doing well and maybe the newspapers are doing well. I don't know anybody else that is doing really well, and I really think the 1986 tax law had a lot to do with it, and I think we ought to make changes in that and bring back some passive losses. Bring back some incentives that do things. We don't have that any more.

Senator **Kerry**. Well, we did lower the tax rate to 28 percent. I mean I'm not going to defend the process. I happen to think that the tax law as to real estate, and I voted against the passive investment changes, and I voted against the retroactivity, and I predicted that both of them were going to be killers to real estate, and I think we are reaping that harvest.

But notwithstanding that, it's hard to say that there isn't an incentive when an individual can walk away with the lowest tax rate we've had in this country in years, and a lot of people are. I mean you look at the disparities in wealth. Read Kevin Phillips today. There are enormous disparities because an awful lot of people have made a lot of money.

Mr. **Maizlish**. Well, I think there is a lot of semantics in that, and we could go on for days offering various theories.

I would like to sit down with you sometime across a cup of coffee and go over various different aspects of this thing, and I think you will find that what I'm saying is not too far off, Senator.

Senator **Kerry**. Mr. Shivers.

Mr. **Shivers**. Senator, the primary problem in Texas has been regulatory overkill. Texas kind of historically has been based on three things, your energy area, real estate and agriculture, and virtually in all three of those areas our economic base went in the dumper at the same time.

Yes, the 1986 tax act did not help the real estate side of it. There is no question about that. Many people were planning their taxes based on real estate investments and so forth, and that hurt and that has taken a lot of the demand away for real estate. But at the same time, the regulatory agencies have increased how stringent the exams are and how they are applying the rules.

A good example is any type of company or local business that is the life blood of this country, those companies, I don't care how long they have been in business, it makes no difference, but if they have showed any type of a loss in their business over the last 3 years, you're almost assured a guaranteed classification of that loan.

Coopers and Lybrand, one of the big eight accounting firms, has done my work for years. The regional partner in the Dallas/Fort Worth area told me the last 2 years with all their corporate clients that have credit needs of $1 to $10 million have had to go out of the State of Texas to get it because there are no banks that or are able to make loans of that size that are willing to make any loans, which is why all out-of-State banks are taking over all our major banks. They want our deposits, but dammit they don't want to put any money into Texas.

Senator **Kerry**. Isn't it true that there isn't a State-owned bank in Texas today that is owned by Texans?

Mr. **Shivers**. Not any large banks.

Senator **Kerry**. That's right, not any large banks.

Mr. **Shivers**. Texas up until 2 years ago was a unit banking State, and we have about 1,600 individual banks. There are still about 800 community banks, which mine is one of them. My bank has $150 million in assets on a good day, but there are a lot of banks like mine out there, and a lot of smaller banks, a lot of country banks trying to meet their community and agricultural needs of the State, but none of the major large banks in the State that met the large credit needs, none of those are locally owned any more.

Senator Kerry. Mr. Cates, how do you respond on that?

Mr. Cates. I would like to respond by dividing New England from the rest of the country. I think in New England there has been a widespread overexpansion of banking with a great admixture of imprudence, and we have seen that developing over several years.

If we have seen it, it means the rest of the private sector has seen it. So credit rating agencies and banks stockholders and bank analysts along with bank examiners have recognized this, and I believe that on the model of Texas, but not as severe, that there will be a period of 2 or 3 years before there is a recovery.

As for the rest of the country, I think that when the FDIC points to areas of real estate weakness in Nashville and California and other places, the prior strength and soundness of banks in most other regions of the country heading into such a situation is so solid that I don't see anywhere near the collision between regulators and bankers and between bankers and credit rating agencies and stockholders that has occurred in New England.

And I believe that the marketplace will adjust to that. I know ways in which banks can go about explaining to their stockholders and large dollars funds providers, their uninsured funds providers what their true situation is.

Mr. Blair. I think that if you look at the three factors, three explanations for the current problem, the economy, the bankers and the regulators, I think we would have to agree that there is some of all three that would have to share the blame.

The problem, and I think Mr. Cates is right, I think where there may have been imprudence, the market would have adjusted. If you leave the economy to its own and the bankers to their own, they would have said, yes, we overextended here or there, but we are going to adjust our lending. They have no incentive to overextend because of stockholders and other constraints, and in fact I think that's an important point on the issue of demagoguery.

I mean the fact is there aren't very many accusations of malfeasance in the New England banks, and there is a big difference between malfeasance and imprudence. That's not to say necessarily that all the loans that were made that are going bad were necessarily imprudent loans at the time, but it's just that there is a big difference between saying that someone did something that was morally or criminally wrong and saying that they did something that was a bad business judgment given what we know in hindsight has happened to the economy.

But what has happened is that the regulators have come in with a sledge hammer to beat the bankers down into submission, and I think that instead what we need is a partnership between the bankers and examiners and some sense that in fact it's in the examiners' interest to see that the banking system get on its feet because, as you've said before, the danger here is that the banking system tightens up liquidity vanishes and the economy stalls, and then everything, the banking system, and the entire economy just goes into a downward spiral.

Senator **Kerry**. Well, I appreciate the answers from all of you, and I particularly appreciate your observations on this, which I think are very helpful.

Regrettably, I have a 4 o'clock meeting that I've got to go to, and I thank you very, very much for your observations.

Senator **Dodd**. Thank you, Senator Kerry, for your observations as well in all of this.

I would just say in conclusion that I was intrigued about your comment about the 1986 tax act. I opposed it. I was one of a handful here who did. I thought we did away with the incentives and disincentives. I've always seen the Tax Code as having dual function, to generate revenues to pay for the legitimate services of Government and, second, to act as an incentive and a disincentive as to encourage or discourage certain behavior that was advantageous to the country or to the contrary, and that will change from time to time, what makes sense and where do you encourage investment and where do you encourage activity.

So by lowering the rates, which was a positive thing, and I don't disagree with that, but nonetheless you pay a price it seems to me in these other areas, and an awful lot of functions in this country that have served the public were supported by the private sector, and not by the Congress. We encouraged the wealthy to do certain things, and the reason they did it was because we made it financially attractive for them to do it. Whether it was in housing or in transportation or in the building of industrial parks for employment or whatever else it was, we encouraged a lot of that activity directly through the Tax Code, things we could never afford to do out of the general Treasury.

By eliminating a lot of those incentives of course, and also with the merging deficits, no one is doing it. We are not doing it certainly from the Federal Government or the State governments, and the private sector isn't doing it. I mean they might as well buy antiques or paintings because there is a larger rate of return.

Mining is a classic example. I mean you put a shovel in the ground and the period of return is on the average 7 years. Now if you don't make that a very attractive investment, if in fact there is a return on it, no one is going to do it, and in fact today no one is doing it.

So the Tax Code, it seems to me that the notion that simple is good is just fundamentally flawed, and I think we are paying a price for it today on many fronts, but that is a minority view here I must tell you as well. We did not prevail.

You all have been very, very helpful. I know there are some additional questions that others may want to submit to you.

Senator **Dodd**. I appreciate particularly your sense of frustration as well over what we do next, but I think the general notion is to keep at this and to encourage the kind of things that Mr. Clarke did in Connecticut over the last couple of days to encourage the examiners and others to talk to the banking community and get them to come forward and to encourage a little more risk taking here is important at this point. When I say risk taking, I think we all have to be careful because the notion is when you take a risk that it's not a calculated or reasonable risk here, and that is what we are talking about I think without any question at all.

But your comments and your participation today have been tremendously helpful to get this message out as to what we are interested in achieving, all of us in this country, and to avoid the kind of catastrophe as we have seen in other parts of the country where frankly maybe not enough of this happened in a timely fashion to raise proper concerns.

So without any additional comments, unless you have them, I will announce this committee stands adjourned until further call of the Chair.

[The committee adjourned at 4 p.m., subject to the call of the Chair.]

[Response to written questions and additional material supplied for the record follow:]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM ALAN GREENSPAN

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

August 6, 1990

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing, and
Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

I am enclosing the answers to the questions you raised in your letter of July 6 relating to my testimony on June 21, 1990, before the U.S. Senate Committee on Banking, Housing and Urban Affairs.

If I can be of further assistance, please let me know.

Sincerely,

Enclosure

Chairman Greenspan subsequently submitted the following in response to written questions from Chairman Donald W. Riegle, Jr., in connection with the hearing held on June 21, 1990.

Q.1. Data suggest that New England and the real estate industries are experiencing credit-cutbacks and/or recessions that are somewhat similar to those felt earlier in Texas and the Southwest. What are the similarities and the differences? How likely is it that these problems will spread to become a national recession? Can such problems interfere with the Federal Reserve's conduct of monetary policy? What can and should the Federal Reserve do to alleviate regional or sectoral recessions?

A.1. There are both similarities and differences between the Texas and New England cases, as you suggest. Obviously, the current economic slump in New England did not have its roots in a reversal of an energy industry boom, but rather in setbacks in the defense, high tech, and financial services industries. In both instances, once the growth of the economy slowed, the overly aggressive building in the residential and commercial sectors became apparent, and the downturn in real estate inflicted heavy losses on lenders. My sense is that the excesses of depository institutions, especially thrift institutions, had a greater role in creating the problems in Texas than has been the case in New England.

Be that as it may, I don't see the sort of direct contagion in these problems that will lead to national recession, and while they are an important feature of the economic and financial environment that must be considered as we make our decisions, I don't believe that they "interfere" with the conduct of monetary policy in a fundamental way. The Federal Reserve does not have the tools to deal surgically with regional or sectoral problems, and indeed, our ability to carry out our general macro-stabilization responsibilities could be hampered, were we to lose sight of that fact.

Q.2. In October 1989, private analysts testified before the Committee that the regulators should limit the dividends paid by undercapitalized banks. What is the Federal Reserve's policy on dividend payments by federally insured banks? Should this policy be tightened?

A.2. The Federal Reserve's policy statement issued in November, 1985 addresses cash dividend payments by state member banks and bank holding companies. It reiterates the Board's view that bank holding companies should serve as sources of strength to their subsidiary banks and states that banks and bank holding companies generally should not maintain dividends on common stock unless:

(1) the organization's net income over the past year has been sufficient to fully fund the dividends and

(2) the prospective rate of earnings retention appears consistent with the organization's capital needs, asset quality, and overall financial condition.

Banking organizations whose cash dividends are inconsistent with either of these criteria are instructed to give serious consideration to cutting or eliminating their dividends. The policy further states the Board's belief that it is inappropriate for a banking organization that is experiencing serious financial problems or that has inadequate capital to borrow or rely heavily on nonrecurring gains for the purpose of paying dividends.

Consistent with this policy, the Federal Reserve has encouraged a number of banking organizations to reduce or eliminate dividends. Flexibility has been applied in the case of some banking organizations experiencing a decline in earnings which was not believed to be representative of their long-term earnings capacity to continue paying dividends.

As indicated in my testimony before the Senate Committee on Banking, Housing and Urban Affairs (July 12, 1990), the Board's dividend policy is currently being reviewed with respect to banks that do not meet minimal capital standards. The review is focusing on a framework in which full in-bank supervisory reviews are conducted at least annually. If such reviews find that a bank's capital, after appropriate charge-offs, is not consistent with minimum capital standards, then the board of directors and the bank's regulators would begin the process of requiring the bank to reduce assets or rebuild equity capital. Further, if credible capital raising commitments are not forthcoming, and if those commitments are not promptly met, a reduction or elimination of dividends would be required, except in cases of unusual mitigating circumstances. Although current supervisory practices incorporate a similar process, the important change being suggested is that all affected parties be given a clear indication that the supervisory responses will occur promptly and firmly.

Q.3. What was the purpose of your meeting with the American Bankers Association on May 10? What was discussed and what was accomplished?

A.3. During the week preceding that meeting, real estate market conditions in a number of areas of the country had softened considerably further, reflecting in some cases a general weakening of regional economies. Bank examinations conducted during these weeks had uncovered problems of considerable severity in the loan portfolios, especially real estate loan portfolios, of all too many banking organizations. These developments were being experienced most intensely in New England. In the face of these developments, many banks were reported to be tightening their lending standards and significantly curtailing their willingness to extend new loans. As a result, business leaders were expressing concerns that the tightening credit conditions would unnecessarily prevent sound business firms from obtaining needed credit and might reinforce recessionary tendencies in regional and perhaps the national economy.

Against this background, the Comptroller of the Currency and the chairmen of the Federal Reserve and the FDIC felt that a meeting with banks and their representatives was in order. One purpose of the meeting was to make the point that the troubled loans examiners were identifying were traceable fundamentally to the deterioration in underlying market conditions. A second purpose was to emphasize that, while it was understandable and, indeed, advisable, for bankers to exercise greater caution in extending new loans in light of the changing economic conditions, it was, nonetheless, both appropriate and important for them to meet the financing needs of credit-worthy borrowers.

Both the regulatory authorities and the bankers generally agreed that the meeting had been useful in that it had provided a means for each group to gain a better understanding of the other's views and concerns on these important matters.

Q.4. The new capital standards for commercial banks exclude loan loss reserves from Tier I capital. In future, heavy provisions for losses made during a recession could reduce a bank's capital and inhibit it from making loans. This constraint could occur at a time when the Federal Reserve wished to stimulate the economy. Do you expect such a capital constraint to alter the conduct of monetary policy? Have you initiated studies to examine this issue? What are their conclusions?

A.4. The Federal Reserve has considered this issue and has concluded that monetary policy would retain its effectiveness, albeit perhaps not through the same channels or in exactly the same ways as in the past. The issue is whether banks' reluctance or inability to make loans might mean that any reduction in funding costs that depositories gain from an easing of pressures on reserve markets would simply be translated into a wider profit margin, rather than passed on to borrowers. If so, any Federal Reserve effort to stimulate the economy might be undermined. But even in the face of such a change in credit supply conditions, the Federal Reserve would retain its ability to lower short-term market interest rates, and it is unlikely that the boost to asset prices and lending margins would not call forth some additional credit extensions by depository institutions. In addition, the lower market rates would spur borrowing by those with access to the open market--including not only large corporations with investment-grade ratings, but also home mortgage borrowers, who effectively tap open-market credit when their loans are bundled together as pass-through securities. Moreover, monetary policy would continue to work through its effects on exchange rates. Nonetheless, during such a period, there would be some additional uncertainties about the intensity of monetary policy effects; thus the situation would demand particularly close attention.

Q.5. The risk-based capital standards give commercial loans a risk weighting that is higher than loans to government or home owners. These weightings may make it more difficult for private industry and small business, in particular, to obtain loans. Are you concerned about this possibility ad what can you do to alleviate problems, if they arise?

A.5. A principle objective we had when developing risk-based capital standards was to distinguish among the different levels of credit risk while minimizing the effect different capital requirements would have on the allocation of credit. This process required us to consider numerous issues from both a domestic and an international perspective. The agreement uses four categories of risk:

(1) claims unconditionally guaranteed by the U.S. government, which carry no credit risk;

(2) claims on banks, government-sponsored agencies and state and municipal governments in the United States and OECD member countries, which are perceived to carry low credit risk;

(3) loans fully secured by first liens on 1-4 family residential properties and that meet other specific provisions, and revenue bonds issued by state and municipal governments, both of which experience has shown carry moderate credit risk; and

(4) all other direct or indirect extensions of credit.

These various risk-weightings do require banks to support loans to private businesses with more capital than is required for loans to certain other borrowers, such as governments or government supported agencies and homeowners. This distinction is based upon differences in the risks associated with these broad asset categories. For example, it is generally accepted that claims on industrial country governments that have taxing authority involve lower credit risks than claims on private businesses.

Risk-based capital standards, then, are intended to encourage banks to maintain capital against assets roughly commensurate with the risk of loss to which banks are exposed. Of necessity a higher capital requirement will result in interest rates charged by banks to private borrowers exceeding those to governments and lower risk credits. This of course is consistent with the general pattern of interest rates established by the markets in which higher rates are charged on riskier credits.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM PAUL G. FRITTS

FDIC
Federal Deposit Insurance Corporation
Washington, D.C. 20429
Office of Legislative Affairs

Q.1. In your capacity as federal insurer of banks and thrifts, do you observe more delinquent loans this year than last year?

A.1. Yes. Noncurrent loans and leases at BIF-insured commercial banks increased 6.8 percent, from $57.7 billion or 1.83 percent of assets, at March 31, 1989 to $61.7 billion or 1.89 percent of assets, at March 31, 1990. At BIF-insured state chartered thrifts, noncurrent loans and leases increased 99.7 percent from $3.2 billion, or 1.35 percent of assets, at March 31, 1989 to $6.4 billion, or 2.65 percent of assets, at March 31, 1990.

Q.2. What is the outlook for the Bank Insurance Fund this year?

A.2. If no large banks fail during 1990, we expect that the Bank Insurance Fund will break even or turn a small profit. However, given current conditions, it is more realistic to project a loss to the Bank Insurance Fund during 1990. It is too early to predict what the results will be.

Q.3. What was the purpose of your meeting with the American Bankers Association on May 10, 1990? What was discussed and what was accomplished?

A.3. The three bank regulatory agencies requested the meeting with the Board of Directors of the American Bankers Association in its Washington headquarters. Representing the agencies were FDIC Chairman Seidman, Federal Reserve Board Chairman Greenspan and Comptroller of the Currency Clarke. The purposes of the meeting were to clear up misinformation and misconceptions in the industry concerning the regulators' examination policies, and to promote open communications between regulators and the banking industry. The bankers were encouraged to screen their loans carefully and to pay close attention to market conditions but to continue to make creditworthy loans.

Q.4. Do you expect the situation for commercial banks in New England to become as serious as it was in Texas and the Southwest?

A.4. No. What occurred in Texas and the Southwest was an extraordinarily severe regional economic depression brought about by a collapse of the energy sector which dominated the economy. Some of the same lending excesses have occurred to a lesser degree in the Northeastern region. However, the economy in New England is much better diversified and able to withstand the shock of an economic downturn.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SASSER FROM L. WILLIAM SEIDMAN

FDIC
Federal Deposit Insurance Corporation
Washington, D.C. 20429
Office of Legislative Affairs

Q.1. The taxpayer bailout of the Savings and Loan Insurance Fund represents the greatest financial crisis since the 1930s, and one of the costliest endeavors of this nation.

Recently, there has been increased attention on the financial condition of the Bank Insurance Fund (BIF), and on the FDIC itself. I am very concerned by reports of what many experts are seeing. According to Robert Litan of the Brookings Institution, the FDIC may have reserves of only $4 billion, rather than its advertised $14 billion. Indeed, the ratio of money in the FDIC fund to insured deposits in the nation's banks is only 0.8 percent -- the lowest since the fund's inception in 1933.

In addition to the problems in the Fund, there are difficulties within the industry. Many of our biggest banks are weighed down with loans to lesser developed countries, as well as leveraged buyouts. There is an escalating real estate recession in the Northeast, and there are continuing problems in the Southwest.

According to R. Dan Brumbaugh, there are 490 commercial banks with $30 billion in assets that have had negative operating income every year since 1986. Of these banks, 70 percent have less than 3 percent capital. Brumbaugh projects that the current losses of these banks will exhaust their capital by the end of this year.

a. Please comment on Brumbaugh's analysis.

b. I realize that we are increasing bank premiums, but are we on the brink of a problem with the solvency of our banks and their insurance fund -- not withstanding the scheduled increase in premiums? Is there anything we can do to strengthen BIF to avert another huge claim on the budget like the one for the S&Ls?

c. Should we consider limiting the scope of deposit insurance to cut back on the exposure of the taxpayers?

d. Are the new instruments like BICs and UITs, where deposit insurance is "passed-through" to shareholders, an over extension of the FDIC's liability?

A.1.(a) As you are probably aware, R. Dan Brumbaugh, Robert Litan, and James R. Barth were hired by the House Subcommittee on Financial Institutions to study the solvency of the Bank Insurance Fund (BIF). The FDIC has been providing these economists with the data necessary to perform their analysis, and we are awaiting their results, due in November. At that time, we will be able to provide detailed comments as to their analysis and their findings.

With respect to the specific data cited in your question, we have not been able to replicate Mr. Brumbaugh's findings. Consequently, we cannot confirm the accuracy of his findings. However, in previous attempts to verify the results of Mr. Brumbaugh's studies, our analysis has frequently yielded conclusions that conflict with those presented by Mr. Brumbaugh. We would like to point out, however, that we have found that many of the banks with sustained earnings losses are newly chartered institutions, a group which we would expect to show negative earnings for some period of time, or they are banks in the Southwest, the region that continues to lead the nation in bank failures. In addition, some of these institutions are in the process of building their reserves against problem loans.

Overall, it is likely that some portion of the thinly capitalized banks reporting earnings losses will fail over the next couple of years, while the rest will return to profitability. Should this be the case, failure rates for banks over the next two years would be within the range we currently anticipate. As for the ability of the BIF to absorb these losses, we believe that the fund is sufficient at this time to handle problems in the industry that we currently foresee. In addition, the financial strength of the BIF will be augmented as increased deposit insurance premiums significantly add to the fund's income over the next few years.

A.1.(b) Without question, the BIF is under considerable stress, and currently stands at its lowest level relative to insured deposits (70 cents for every $100 dollars of deposits at year-end 1989) since its inception. Given the growing real estate problems in many parts of the country and a generally weakening economy, the BIF could sustain a loss of $2 billion or more this year. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) required the FDIC to raise insurance premiums to 12 cents for every $100 of deposits this year, and to 15 cents for every $100 of deposits in subsequent years. However, FIRREA also has provided the FDIC with the flexibility to increase premiums by as much as 7.5 cents in a given year, if there is perceived to be a "significant risk of substantial future losses" that could potentially threaten the solvency of the fund.

Accordingly, the FDIC has taken steps to increase BIF premiums to 19.5 cents for every $100 of deposits in 1991, the maximum allowable increase for the year. We estimate that this increase will generate an additional $1.1 billion premium income over the scheduled increase, with minimal impact on current industry capital levels. This measure was necessary to build reserves and to protect the integrity of the BIF. This premium increase is an important step toward strengthening the BIF, so that a claim on the federal budget will not prove necessary in the future.

A.1.(c) As we consider the various measures for reform of the deposit insurance system, it is imperative that we find a way to reduce the safety net and to limit the potential exposure to the government created by this guarantee. Reform must be accomplished without jeopardizing the stability of the financial system, and without hampering banks' ability to compete in a rapidly changing national and international marketplace. At the same time, we must recognize that meaningful reform will not be without cost to banks and their customers. As a first step toward reform, we believe we need to look at banks' assets, liabilities, and the industry's structure in order to control the cost of deposit insurance.

With respect to banks' assets, the types of investments that may be made with insured deposits must be limited. This means examining not only what banks may be permitted to do in the future, but also evaluating the risks in the activities in which banks are currently permitted to engage. Only those investments that experience indicates are reasonable, conservative, and safe should be funded with insured deposits.

The exposure of the government also can be reduced by limiting what liabilities it insures. One possibility is to restrict the amount of liability per customer. Proposals such as co-insurance, reducing coverage by decreasing the $100,000 limit, or limiting the number of insured accounts per person, are other means of reducing the government's exposure.

The "too-big-to-fail" concept also should be reexamined. While the FDIC is in favor of reducing its insurance liability, any decreases in coverage must take into account any resultant increased instability. Regardless of the statutory coverage limits, those responsible for preserving macroeconomic stability may not want their flexibility to handle the failure of a large bank restricted. Moreover, given global competitiveness considerations, it may be unwise for the United States to make a unilateral decision regarding the "too-big-to-fail" concept without first gaining some consensus on this issue from the international community.

In terms of structure, while it is probably appropriate to expand the activities allowed outside the bank -- in holding companies or subsidiaries -- we need to ensure that adequate protections are in place to prevent insured deposits from being used to fund such activities. Other areas to consider include increased capital requirements, risk-based premiums, risk-based capital, limiting pass-though insurance, and private co-insurance. At all times, the costs and benefits of each of these proposals to limit the government's liability should be weighed against the overriding goal of system stability.

A.1.(d) As directed by FIRREA, the FDIC has completed a detailed study entitled Findings and Recommendations Concerning "Pass-Through" Deposit Insurance (February 1990). In this study, the FDIC's statutory authority for providing pass-through deposit insurance is outlined, and the merits of this type of coverage from an economic and public-policy standpoint are discussed. (We would like to note that UITs are not afforded pass-through coverage, as the question suggests, pursuant to a specific regulation adopted in 1977, which treats UITs as corporations for deposit insurance purposes.)

Under the current system of deposit insurance, the FDIC has both a statutory and a precedential basis for extending pass-through coverage to BICs. The FDIC has taken the position that a BIC qualifies as a "deposit" as defined in the Federal Deposit Insurance Act as amended in 1950, and as such is afforded pass-though deposit insurance coverage. These instruments are not materially different from traditional certificates of deposit which historically have received pass-through coverage. Under the FDIC's regulations, the deposits of most pension plans, profit sharing plans and other trusteed employee benefit plans are entitled to pass-through insurance coverage as long as the FDIC's recordkeeping requirements for pass-through insurance are satisfied.

Ultimately, the extent to which pass-through deposit insurance should be provided for various owners and types of deposits should be addressed in the context of the comprehensive review of the deposit insurance system. That review will consider who is entitled to how much deposit insurance, on a direct or pass-through basis, and for what public-policy reasons. Under the current system, however, the FDIC does not perceive its rules regarding pass-through coverage to be an over-extension of coverage. Altering pass-through coverage without addressing the broader questions of deposit insurance reform will have little, if any, impact on the scope of the FDIC's liability.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM

Robert L. Clarke

Comptroller of the Currency
Administrator of National Banks

Q1. Why did OCC not anticipate and forestall the problems, particularly the real estate problems, that have occurred in New England? Have you investigated whether anything went wrong in the New England district office? Have you needed to take any disciplinary actions?

A1. The OCC has been warning banks about the potential for losses in real estate lending since 1988. For example, in a 1988 advisory letter, the OCC alerted the chief executive officers of all national banks to the importance of following prudent real estate lending practices. After analyzing 13 of the largest regional banking companies in the country we noted that "many banks had informal underwriting standards rather than written policies. Some standards ha[d] become fairly liberal when compared to historical practices...equity standards ha[d] been liberalized over the ~~years,~~ and a few of the banks analyzed sometimes failed to require any invested equity in their financed projects." We also noted a number of policy exceptions and deficiencies in appraisals and market analyses.

The letter also stressed that banks with "large concentrations of loans to a relatively small number of developers...were thus particularly vulnerable to a downturn in the economy, even though the borrowers [we]re considered top-tier." In that advisory, I stated that I was not suggesting banks stop making commercial real estate loans, but instead that they take a close look at how and where they are making them. This message has been repeated in public addresses that I have delivered around the country.

During most of the 1980's until mid-1989, real estate projects were generally successful and profitable investments for banks. During that period, our examiners warned banks of the potential threat, and encouraged careful monitoring and sound underwriting. It is not always easy to determine, at the time or in retrospect, exactly how much supervisory involvement is appropriate. We must balance the need to maintain safety and soundness with the rights of bank managers to make independent decisions. When problems are forecasted but not yet manifested, our efforts are generally limited to attempting to ensure that bank management has implemented controls and processes designed to help their institutions weather potential problems.

Obviously, the problems currently being experienced by some New England banks raise the question of whether the OCC could have done more. With the benefit of hindsight, it would have been desirable to deal more aggressively with banks at an earlier stage by insisting that management correct previously identified deficiencies in their systems. Based on developments in New England, I decided it would be desirable to make some changes in the Northeastern District office and to augment the number of examiners stationed there. I did not feel disciplinary actions were required.

Q2. What is your philosophy of bank examination and supervision? How has your approach evolved since you became Comptroller of the Currency?

A2. The primary function of bank supervisors is to ensure that the banking system operates soundly and that banks comply with the law. The OCC uses a supervisory process designed to encourage and reinforce sound decision-making by bank managers. As bank supervisors we work to ensure that:

- banks adopt and adhere to sound credit policies;
- each bank's books accurately reflect the value of its assets and liabilities; and
- banks establish management systems that are capable of tracking bank activities and can reasonably anticipate and adjust to changing market conditions.

We work to ensure that banks accurately report the condition of their portfolios and maintain reserves that are adequate to protect against anticipated losses. During this process we must also handle bank failures in a manner that minimizes the cost to society and to the insurance fund.

The supervisory process is complex and requires judgment. The OCC strives to ensure that a banker has an understanding of his or her financial institution's condition that is reasonable and accurate. Bank management must be able to support its decisions to its board of directors and shareholders. So we encourage, and when necessary compel, national bankers to focus on the quality of their investments and, if necessary, to improve them. Our goal is to ensure that banks adhere to sensible credit standards that protect their safety and soundness and at the same time to encourage banks to lend to creditworthy customers and to serve the needs of their community.

Under the supervisory process, each bank is assigned to an examiner who develops a strategy for supervising that institution. The strategy is based on a variety of factors including quality of management; scope of the bank's operations; adequacy of the bank's policies, procedures, planning process, internal controls, audit coverage and problem loan identification systems; overall financial performance; and any other factors that might have an impact on the level of risk in the bank.

This supervisory process was in the initial stages of implementation when I arrived at the OCC. We changed our emphasis from a calendar-driven snapshot evaluation to an ongoing review and testing of control systems for all of a bank's risks. We reviewed the process at that time to evaluate whether it would be effective and we have continued to evaluate and modify it as our experience warrants. We have found that our supervisory process allows examiners to detect many problems at earlier stages and gives them greater flexibility to respond to new developments as they arise.

- The supervisory process has evolved and improved over time, resulting in more effective supervision of national banks. The development of risk-based capital standards and the equity insolvency rule are two recent examples of improvements to the process. We believe that our methods of supervision, coupled with initiatives to increase the capital positions of banks relative to the risks they assume and to ensure timely closure of insolvent banks, will help maintain the public confidence which is vital to the proper operation of the banking system.

Q3. What was the purpose of your meeting with the American Bankers Association on May 10, 1990? What was discussed and what was accomplished?

A3. Federal Reserve Board Chairman Alan Greenspan, FDIC Chairman L. William Seidman, and I met with the board of directors of the American Bankers Association to allay fears among bankers that regulators would criticize prudent bank lending. In that meeting, we stressed that recent reviews of real estate lending at major state and national banks in New England were cooperative processes which involved examiners from all three federal bank regulatory agencies.

These reviews uncovered problems that resulted in increases in criticized loans, provisions for loan loss reserves, and more loans being placed in nonaccrual status. These actions were appropriate and were warranted by the economic changes in the region. However, they were not meant to encourage banks to pull back from lending to creditworthy borrowers. All of us expressed our belief that it is appropriate for banks to continue lending -- that qualified borrowers exist and that they represent important business opportunities.

We believe this message was well-received by the bankers that attended the meeting. To make sure our views are widely heard I have repeated the message in meetings with Members of Congress and state governors as well as in speeches I have given all over the country to bankers, businessman, and local community leaders. I believe our views are being understood and that most bankers are continuing to lend to creditworthy borrowers.

Q4. What effects have you observed from the recent "OCC Advisory" on deficiencies in real estate lending by national banks?

A4. The attached "OCC Advisory" (90-2) on real estate project and development lending by national banks was issued February 8, 1990. The purpose of all advisories is to give the broader segment of the national banking community the benefit of what we are observing in our evaluation of individual banks. It is part of our emphasis on early warnings. However, it is difficult to measure the impact of such an advisory. We do know that banks are actively assessing the quality of their loan portfolios either through internal means or by use of outside professionals. The advisories are intended to be early warning indicators, based on what our examiners are seeing. They are not intended to stop certain categories of lending.

Q5. Several prominent banks in New England have recently made large provisions for loan losses, following targeted real estate examinations. Apart from its recent examination, when did each of these banks last receive an on-site examination from the OCC?

A5. The OCC's approach to supervision of regional and multinational banks involves developing individual bank strategies based on such issues as: financial data, economic trends, and the quality of bank management. The OCC stations resident examiners in all multinational banks to monitor developments and identify risks requiring examiner attention. Periodic (generally quarterly) off-site analyses are performed using the latest available financial information as well as economic data. The regional and multinational banks in New England have been supervised in this manner at least since 1987. Whenever off-site analyses indicated areas of concern or deteriorating trends, on-site reviews were conducted focusing on the areas of concern such as asset quality, earnings performance, compliance, liquidity, and management supervision.

THE HONORABLE JOHN HEINZ

QUESTIONS FOR ROBERT L. CLARKE,
COMPTROLLER OF THE CURRENCY

Pursuant to the Hearing before the
Senate Banking, Housing and Urban Affairs Committee
on June 21, 1990

Q.1. The OCC recently proposed major revisions to its regulations concerning collective investment funds managed by national banks and federally chartered savings associations. The proposal in effect would open up a new line of investment services for these institutions to offer in combination with their depository services. The comment period on this proposal closed over a month ago. You and others in your Office have downplayed the significance of this proposed rule making. The detailed analysis done by state attorneys general and securities administrators, as well as by associations representing some 3,300 independent/community banks around the country, suggests that the proposal has far wider and more serious ramifications than the OCC has acknowledged. Numerous members of Congress have written you urging the OCC to withdraw or postpone the implementation of this proposal pending the development of the Administration's financial industry restructuring plan. I have written earlier to you making a similar request. I now understand that the OCC recently extended the period for comments on its proposal by 60 days, until July 8. Why did the OCC extend the comment period? If the proposal is indeed as modest a measure as you suggest, why will you not now agree to withdraw or at least delay this rulemaking until Congress and the Administration have time to consider these larger, more fundamental issues?

A.1. The OCC has not proposed in its February 1990 notice of proposed rulemaking to expand the powers of national banks or to open up a new line of investment services. The underlying purpose of the proposal is to codify decisions of several U.S. Circuit Courts of Appeals governing the collective investment of Individual Retirement Accounts and reduce the burden of certain regulations governing the fiduciary activities of national banks that either duplicate, overlap or conflict with federal, state, or common law requirements. Among other things, the regulation would allow banks to advertise presently authorized collective investment services alone, instead of together with other fiduciary services as banks long have been permitted to do. Thus, I must disagree that the proposal is intended to allow banks to offer a new line of investment services in combination with depository services. It would allow banks to charge fees for providing collective investment services in much the same manner as state chartered banks. In no respect does the proposal seek to remove any national bank fiduciary activity from regulatory oversight, applicable state law, rules, and regulations and traditional fiduciary responsibilities. Because banks already possess these powers, the rulemaking would not expand bank powers or prompt violations of the Glass-Steagall Act.

Because the comment period on the proposal recently has closed and review of the comments has begun, it is too early for the OCC to characterize the views of commenters on the proposal. It is clear that a large number of commenters expressed a wide spectrum of views both in favor of and in opposition to the proposal.

The OCC reopened the comment period on the proposal for 60 days so that it could take into consideration the many comments that we received following the close of the initial comment period. In this way, we have tried to assure that the views of all interested parties are taken into account before we take final action on the proposal.

The OCC has proposed these amendments as part of a process that began in 1982, when it published an advance notice of proposed rulemaking for the issuance of regulations governing the establishment of common trust funds for individual retirement accounts. In November 1984, the OCC suspended its consideration of that proposal pending resolution of several cases challenging the authority of national banks to engage in the collective investment of individual retirement accounts. These cases ultimately were decided in favor of national banks' authority to engage in these collective investment activties. Consequently, because the current proposal does not involve a departure from previously authorized bank activities, and is not related to proposals to restructure the nation's financial industry, we believe there is no reason to await congressional action on unrelated Glass-Steagall Act reform or deposit insurance reform.

Q.2. The rulemaking loosens current federal rules regarding the imposition of fees by collective investment funds. In a May 23, 1990, letter to Congressman Annunzio, you stated that the OCC proposal would simply allow national banks to impose fees equivalent to those currently charged by state chartered banks. The legal analysis available to me challenges this assertion. I assume your Office has conducted a comprehensive review of state laws and regulations in this area, and the fee arrangements used by State-chartered fiduciaries. Would you provide this Committee the results of your review, including a detailed analysis of those states that authorize their State-chartered institutions to charge fees above and beyond those the OCC currently authorizes to national banks?

A.2. We have not performed a fifty state survey of state law governing the fees that state-chartered bank fiduciaries may charge. One of the fundamental purposes underlying this rulemaking proposal is to put national banks on an equal footing with state-chartered banks by removing that portion of OCC regulations that duplicates or conflicts with existing state law requirements. With respect to permissible fee structures, the proposed rule would specify that national banks may charge reasonable fees to the extent permitted by applicable state and federal laws and regulations. In other words, if the proposed rule change is adopted, a national bank could not charge any fee that would be greater than what a state bank could charge for the same trust service. Thus, national banks would be required to observe state statutory and common law requirements as well as applicable provisions of federal law such as ERISA in the case of pension and employee benefit plans. In addition, the OCC would retain the current requirement set forth in 12 C.F.R. § 9.15(a) that, where fees are not set out in local law or agreed to by the parties in the governing instrument, all fees charged must be "reasonable."

This overall approach is consistent with the requirements of 12 U.S.C. § 92a that subject bank trustees to state and local law. Therefore, although the OCC has proposed to remove specific fee limitations, national banks will not be free to charge unlimited fees. Instead, they will be on an equal footing with state-chartered banks, subject to "State or local law" requirements and limitations on the fees that state banks may charge.

Q.3 Please describe what financial impact the increased fees that would be authorized under the draft regulations will have on trust beneficiaries. Could you provide this Committee specific information as to the amount of fee increases that the average personal trust account and individual trust beneficiary is likely to see as a result of this rule, and the aggregate amount of new fees and expense industry-wide that this is likely to occasion?

A.3. The impact of the proposed revisions, if adopted, would depend on a variety of factors, including the types of common trust funds offered by bank trustees and customer choices among competing fiduciary service providers. As stated above, should the proposal be adopted, national banks would remain subject to OCC regulations and state law fiduciary standards requiring that fees be reasonable and would be restricted by other state law provisions on fees. Competitive forces also would play an important role in restricting fees charged by national bank trustees. The proposal may make it economically feasible for banks to offer a wider variety of options to trust customers for the placement of trust assets. While some of these options could carry higher fees, subject to limitations of applicable state and local law, these options also could result in greater overall returns to beneficiaries.

Q.4.A. A good deal of concern has been expressed about the potential conflicts of interest between banks and savings associations and their common trust fund customers. The OCC proposal would permit these institutions to increase their fees and recover additional expenses -- including advertising costs -- simply by exercising their investment discretion to put customer assets in their collective investment funds, as opposed to some other investment vehicle. Could you comment on why the OCC proposal discounts the risks of these conflicts of interest, whereas existing regulations are designed specifically to avoid them?

A.4.A. The proposed revisions to OCC fiduciary regulations governing permissible fees would not alter important fiduciary principles that would continue to govern the actions of bank trustees. One such principle is the requirement that the bank trustee act in the best interest of beneficiaries. Another principle is that trustees are prohibited by their duty of loyalty, for example, from taking a fee that is unreasonable. Further, bank fiduciaries are under an obligation to observe the terms of underlying trust agreements for permissible investments. In deciding how to proceed with the rulemaking, the OCC will review with care the comments on conflicts of interest that could arise should bank trustees be allowed to charge certain types of fees.

Q.4.B. Banks currently invest only a small percentage of trust assets in their collective investment funds. With the incentive of substantially increased fees and recovery of expenses, won't the OCC proposal result in a far higher percentage of trust assets being invested in collective investment funds?

A.4.B. Established fiduciary principles prohibiting conflicts of interest would preclude banks from loading their own funds with trust assets solely in an effort to gain fee income at the expense of beneficiary interests. To the extent that the proposed regulation would permit banks to operate common trust funds in a more efficient manner, it is likely to result in more banks being able to establish such funds. Moreover, to the extent it would permit banks to provide competitive collective investment vehicles for placement of their fiduciary accounts, it may result in a higher percentage of those assets being placed in their funds, subject to the terms of underlying trust agreements governing permissible investments. The impact of the proposed revisions, if adopted, on investments in bank collective investment funds for trusts ultimately would depend on a variety of factors, including whether banks could create competitive common trust funds with more favorable overall rates of return than other trust asset placement options.

Q.5. As of 1988, there were some 2,673 collective investment funds managed by national banks around the country. The proposed rule states that the OCC anticipates many more such funds might be established if the rule is adopted. Previously, you have expressed concern about the inadequacy of the OCC's examination capabilities with respect to national banks' commercial activities. Do you have similar concerns about examination of trust activities? I am advised that the OCC has little or no specialized trust examination capability, and a recent reorganization of your Office involved a downgrading of trust responsibilities within the OCC, with broader delegation to field offices and less involvement by your staff in Washington. If the rule is adopted, what makes you think the OCC's oversight capabilities will be sufficient? Please provide the Committee a detailed analysis of the OCC's existing trust (as opposed to commercial) examination personnel, resources and practices, including with respect to national bank collective investment funds.

A.5. While the OCC always is concerned with maintaining its ability to meet its obligation to supervise the national banking system within its level of resources, I am satisfied that the OCC is in a strong position to supervise effectively the trust activities of national banks. This position is being strengthened through the adoption of risk-based trust examination procedures to focus the supervisory efforts of the OCC on those banks with the greater need for supervision, without sacrificing the obligation to provide supervision for the national banking system as a whole. These procedures have been developed by trust examination experts in the OCC and are being implemented in all regions of the country. We are enclosing a copy of our Compliance Handbook which includes trust examination procedures. The examination of fiduciary activities is being conducted as part of our compliance program.

The recent reorganization of our Washington office is the result of an effort to reduce duplicative review efforts and concentrate examiner expertise and resources in the field, where examinations are being conducted. The OCC no longer has a group of separately commissioned Trust Examiners, but this does not mean that the OCC lacks adequate staff who possess specialized knowledge in the trust examinations area. Each District Office has responsibility to and does ensure that sufficient numbers of National Bank Examiners are trained to permit comprehensive examinations of the fiduciary activities of all banks in those areas. Given these resources, we believe that the OCC has sufficient staff capability to supervise bank fiduciary activities should the proposal be adopted.

Comptroller of the Currency
Administrator of National Banks

Comptroller's Handbook for Compliance

January 1989

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The objective of these procedures is to determine the quality of management's supervision of the bank's fiduciary activities. This assessment should include:

- Competence of management.
- Effectiveness of the organizational structure.
- Adequacy of written policies and procedures.
- Effectiveness of management information systems for monitoring fiduciary activities.
- Soundness of management's planning and decision making process.
- Evaluation of financial performance.
- Effectiveness of marketing strategies.

Tier I

PROCEDURES

1. Determine the adequacy of the bank's overall fiduciary management practices by reviewing:
   a. The bank's bylaws (if any changes affecting the fiduciary activities have occurred since the last examination).
   b. The minutes of the board of directors and all fiduciary related committees.
   c. Resumes of all senior officers involved in fiduciary activities not obtained during previous examinations. (DS VII-2)
   d. Current organization chart(s), job description(s) and organization plan(s) for fiduciary activities. (DS VII-1)
   e. Most recent annual and interim financial performance data for fiduciary activities to assess profitability.
   f. Outlines of current training programs. (DS VII-3)
   g. Current analysis of investment performance for fiduciary activities.
   h. Current year and future business plan for fiduciary activities, including products and services development and marketing plans. (DS VII-4)
   Fiduciary policies and procedures to determine if: (DS VII-6)
      - They cover adequately all areas of fiduciary activities in which the bank engages.
      - They are reviewed and updated periodically by the board or a board-appointed designee.
      - Policy and procedure manuals are readily available for use by all personnel involved in fiduciary activities.
2. Determine whether management has an information system that informs it fully of the status of all activities within the department and can be relied upon when making management decisions.
3. Determine whether the bank obtains opinion of counsel on important legal matters as follows:
   a. Pending or threatened litigation, claims or assessments.
   b. Governing instruments involving unclear, ambiguous or complicated points of law.
   c. Any transactions involving possible conflicts of interest.
4. Review pending and threatened litigation involving the bank in its fiduciary capacity and determine whether: (DS VII-7)
   a. A weakness exists in any operating policy or procedure.
   b. Possible losses to the bank are significant.
5. Discuss the following with management:
   a. Violations of law, rulings, regulations or significant internal control deficiencies, emphasizing particularly their causes.
   b. Recommended corrective action for deficiencies cited.
   c. Bank's commitment to specific actions for correcting deficiencies.
6. Summarize your conclusions about the bank's policies, procedures and practices regarding fiduciary operations. This summary should focus on:
   - Material policy deficiencies.
   - Material internal control weaknesses.
   - Violations of laws, rulings and regulations.
7. Update appropriate work programs.

The objective of these procedures is to determine whether the bank's systems and controls in its fiduciary operations adequately:

- Safeguard fiduciary assets.
- Ensure the accuracy and reliability of accounting data.
- Provide timely management and account information.
- Maintain levels of operating efficiency.
- Ensure compliance with laws, rules, regulations and bank policies.
- Accommodate new financial products and services and future growth.

When evaluating this section, examiners should focus on the effectiveness of the internal control systems implemented by the bank to ensure compliance. The extent of testing should be based on work performed by internal/external auditors and/or other internal compliance review units and formalized policies and procedures, and the effectiveness of management information systems.

For substantial deficiencies disclosed in audit/compliance reports, determine whether corrective action has been taken or if not, why not.

Tier I

PROCEDURES

1. Determine whether the bank's policies and procedures for allocating operations and administrative functions and supervisory responsibilities among personnel require adequate separation of duties and responsibilities.
2. Review and evaluate the system(s) for safeguarding assets, including protective measures used in their control, receipt and disbursement. (12 CFR 9.8 and 9.13)
3. Review and evaluate safeguards established to ensure proper performance of any agents engaged by the bank to conduct the bank's fiduciary business or to provide support services. (DS VII-17)

   Determine whether bank management has evaluated the safety, reliability and confidentiality of the services.

   If necessary, review the contracts and inspect the subject bank's reconciliation of the accounting records, safekeeping lists, etc.
4. Determine whether the bank's operating procedures promote reliability of the accounting records by:
   - a. Reconciling demand deposit accounts.
   - b. Reconciling suspense, operating, other "house" accounts or related depository accounts (dividend and interest suspense, security purchase and sale suspense, fee suspense, etc.).
   - c. Complying with the OCC minimum standards of information for banks utilizing trust EDP systems.
5. When account assets are held by outside depositories, such as correspondent banks and central depositories, or pledged as collateral for loans, review and evaluate the bank's procedures to ensure that:
   - a. Acknowledgments of receipt are obtained, evidencing such assets and bank fiduciary ownership.
   - b. Appropriate records are maintained, indicating where the assets are held.
   - c. Periodic statements of the assets held and dividends and interest received thereon are reconciled with the bank's records and any discrepancies are corrected promptly.
   - d. Appropriate safeguards are taken for the release of assets from such depositories only upon the direction of designated custodians.
   - e. Assets are protected properly by physical safeguards and adequate insurance coverage.
6. Evaluate the adequacy of policies and procedures regarding called bonds, tender offers and other corporate reorganizations.
7. Determine whether the bank has procedures to evaluate and review periodically the qualifications of broker/dealers in terms of: (12 CFR 9.5)
   - a. Financial condition.
   - b. Knowledge of the market, specific securities, and industries.
   - c. Access to sources of supply or the market.
   - d. Ability to handle block trades.
   - e. Acceptable recordkeeping, e.g., timely and accurate.
   - f. Acceptable record of good and timely delivery and payment on trades.
   - g. Quality of research material and services, such as earnings reports and news bulletins.
8. Review the adequacy of written policies and procedures for brokerage placement practices and evaluate the reasonableness of commissions paid in relation to any brokerage or research services being provided. (12 CFR 9.5) (TBC-25)
9. Determine whether the bank has established appropriate policies and procedures for recording and processing securities transactions. (12 CFR 12)
10. Determine whether the bank has fiduciary errors and omissions insurance coverage or other insurance coverage that could be used to defray fidu-

ciary losses, including any reserves established under a self insurance program. (DS VII-5)

11. Determine whether the bank follows proper cash management practices, which include: (12 CFR 9.10)
    a. Making cash produce income within a reasonable period of time.
    b. Ensuring that a prudent rate of return is obtained for trust quality short-term investments for funds awaiting investment or distribution, consistent with the requirements of the governing instrument and local law.
    c. If the bank uses an automated cash management system, that:
        - Minimum investment balances are considered reasonable for the proper management of the account.
        - Fees assessed to accounts are permitted by local law and are reasonable and properly disclosed. (12 CFR 9.15)
12. Determine whether the bank's procedures ensure that overdrafts are permitted only temporarily, corrected as soon as possible and kept to a minimum.
13. Assess whether the bank complies with the following securities pledge requirements:
    a. Eligible securities are set aside to secure trust funds on deposit with the bank. (12 CFR 9.10(b))
    b. When required by local law, securities are deposited with the state authorities to protect private or court accounts. (12 CFR 9.14)
    c. Pledges are computed regularly and accurately.
14. When applicable, determine whether management administers the time deposit open account in accordance with Regulation D.
15. Determine whether the bank has established proper controls and safeguards for its securities lending activities. (BC-196)
16. Determine whether reports filed with the OCC were compiled according to OCC instructions by: (12 USC 161) (12 USC 1817)
    a. Testing the accuracy of the worksheets, using bank records.
    b. Comparing amounts in the reports to the bank's worksheets.

    NOTE: The bank must file the following reports: the Annual Report of Trust Assets—FFIEC 001; the Annual Report of International Fiduciary Activities—FFIEC 006; and the Special Report—Fiduciary Activities—OMB 1557-0127.

    Coordinate this procedure with the examiner assigned to perform the Regulatory Reports program of the Commercial section.
17. Determine, when applicable, if the bank has filed Schedules 13D and 13G, and Form 13F as required by the Securities and Exchange Act of 1934. (17 CFR 240.13d-101) (17 CFR 240.13(d)) (17 CFR 249.325) (17 CFR 240.13f)
18. Determine whether the bank, pursuant to the requirements of SEC Rule 17f-1 (The Lost, Stolen, Missing and Counterfeit Securities Information System) has: (12 CFR 240.17f-1)
    a. Registered with the Securities Information Center (SIC).
    b. Installed procedures to report to and, as a direct or indirect inquirer, make inquiries of the Commission or its designee concerning the securities specified in the rule. The current designee of the Commission is the SIC.

    Coordinate this procedure with the examiner assigned to perform the Regulatory Reports program.
19. Determine whether the bank has established appropriate systems to ensure that it has met its obligations in connection with shareholder communications and proxy processing. (17 CFR Part 240.14)
20. Review the results of work performed in Tier I. If the results reflect significant violations and/or control deficiencies, or you are unable to reach a conclusion, perform additional procedures, as necessary, in Tier II.
21. Discuss the following with management:
    a. Violations of law, rulings, regulations or significant internal control deficiencies, emphasizing particularly their causes.
    b. Recommended corrective action for deficiencies cited.
    c. Bank's commitment to specific actions for correcting deficiencies.
22. Summarize your conclusions about the bank's policies, procedures and practices regarding fiduciary operations. This summary should focus on:
    - Material policy deficiencies.
    - Material internal control weaknesses.
    - Violations of laws, rulings and regulations.
23. Update appropriate work programs.

Tier II

PROCEDURES

1. Determine whether the bank's procedures provide for the physical protection of account assets, unissued securities of corporate trusts and transfer agencies, and unissued checks. The procedures should include:
   a. The proper holding, receiving or withdrawing of securities, other assets or unissued checks in or from the vault or securities cage of the bank, including: (12 CFR 9.13)
      - Prompt posting of assets to accounting records. (12 CFR 9.8)
      - Joint custody or control of assets. (12 CFR 9.13)
      - Physical security measures which include following the guidelines of the Bank Protection Act of 1968 and using lock protection, alarms, records of vault entrance and other measures. (12 CFR 21)
      - The prevention of access by unauthorized personnel to the vault, the securities cage or other areas where securities are held or handled.
      - Use of pre-numbered receipt or withdrawal forms or fanfold tickets for the deposit or withdrawal of assets, the accuracy of which is verified and authenticated in writing by joint custodians.
      - If an on-line terminal is used for posting, whether:
        —It is located in a limited access area.
        —Passwords are required to enter the system.
        —Changes to the central customer information file are initiated by appropriate parties and supported by adequate documentation.
      - Adequate insurance of securities delivered by mail.
   b. The safeguarding of assets in the residence of a decedent until assets are brought to the bank or distributed.
   c. Keeping fiduciary assets separate from bank assets. (12 USC 92a(c)) (12 CFR 9.8)
   d. Obtaining receipts or similar acknowledgments when assets or unissued securities are not held in the bank's vault.
   e. The special handling of assets received by mail but not specifically addressed to fiduciary areas of the bank.
   f. Giving pre-numbered receipts to messengers or couriers upon delivery of assets.
   g. Controlling unissued checks in the vault and recording those withdrawn.
   h. Permitting withdrawal of assets held elsewhere only on written joint order or confirmation by authorized personnel through special codes or other acceptable method.
2. Determine whether the bank controls and monitors the use of facsimile signature device(s).
3. Determine whether the bank's accounting procedures provide for:
   a. Appropriate separation of duties between preparation of input, processing and reconcilement activities.
   b. Arriving at and maintaining general ledger controls.
   c. Confirming after posting that the aggregate of debits and credits posted to the system agree with posting totals generated by the automated system.
   d. Taking periodic trial balances of fiduciary ledgers.
4. Determine whether the bank provides an appropriate division of duties for the authorization, signing and mailing of fiduciary checks.
5. Determine whether the bank subscribes to a service that provides information about called debt issues and whether bonds are promptly redeemed.
6. Determine whether assets of accounts, other than agency and custodian, are registered in the name of the bank in its fiduciary capacity or a nominee name that is:
   a. Subject to a partnership agreement that is amended as required.
   b. Approved by the board of directors.
   c. Registered with:
      - The American Society of Corporate Secretaries (to guard against duplication of the nominee name).
      - State authorities, where required by local law.
7. If another institution, as agent for the subject bank, performs fiduciary functions, determine that the subject bank:
   a. Establishes such relationship with the agent pursuant to a written agreement that conforms to OCC requirements.
   b. Retains control over investment decisions and other discretionary responsibilities.
   c. Ascertains that cash in each account on deposit with the agent bank does not exceed the amount covered by deposit insurance.
   d. Determines that it is advised of all transactions and recommendations pertaining to discretionary matters, etc., in a timely fashion.
   e. Reviews the adequacy of the agent's perfor-

mance in the administration of accounts by inspecting the agent's transaction ledgers and other accounting records to determine whether transactions are proper, and evaluates such factors as accuracy, promptness in communicating with the fiduciary bank, compliance with the governing instrument, laws, regulations and sound fiduciary principles. An agent's transaction ledgers should be submitted to the fiduciary at least monthly.

f. Acts promptly in transferring assets, documentation and pertinent information to the agent.

Shareholders Communications Rules

The Securities and Exchange Commission has promulgated rules that implement the Shareholders Communications Act of 1985. The law gave the SEC jurisdiction to regulate the proxy processing activities of banks. The regulations govern the distribution of proxy materials and the disclosure of information about shareholders whose securities are registered in a bank nominee name.

8. Determine whether the bank has written policies and procedures to govern its obligations in connection with shareholder communications and proxy processing. (17 CFR Part 240.14)

9. Evaluate whether the bank has determined its voting responsibilities for each security held in its accounts.

   NOTE: For purposes of Rule 14b-2, "beneficial owner" includes any person who has or shares the power to vote, or to direct the voting of a security. The bank does not have to make this determination for securities held on behalf of other banks. (14b-2(h)(i))

10. For accounts opened on or before 12/28/86, determine whether the bank has made a good faith effort to obtain affirmative consent for disclosure of beneficial owner information. (14b-2(h)(i))

11. For accounts opened after 12/28/86, determine whether the bank has contacted existing customers, and established appropriate procedures for new customers, to solicit their non-objection to disclosure of beneficial owner information. (14b-2(h))

12. Determine whether the bank maintains adequate records of beneficial ownership information for each of its accounts (e.g., names, addresses and securities position, and identification as consenting or non-objecting).

13. Test compliance with established timeframes under Rule 14b-2 by reviewing requests for information received by the bank and determining whether:

    a. When the bank receives a request from an issuer for a list of its beneficial owners in accordance with 14a-13(b)(1) (Direct Communication), the bank responds:
       - Within 1 business day, by indicating the name and address of each of its respondent banks, if any.
       - Within 5 business days of receipt, by compiling a list of names, addresses and securities positions for both non-objecting and consenting beneficial owners.
       - Within 5 business days of compilation, by forwarding the list of beneficial owner information to the issuer. (14b-2(e))

    b. When the bank receives an inquiry from an issuer in accordance with 14a-13(a) (Indirect Communication), the bank responds:
       - Within 7 business days, by indicating the approximate number of beneficial owners of securities held directly by the bank.
       - Within 1 business day, if applicable, by indicating the name and address of each of its respondent banks, if securities are held by those banks. (14b-2(a))

    c. Within 3 business days after the record date, the bank:
       - Executes an omnibus proxy in favor of its respondent banks and forwards such proxy to the issuer.
       - Furnishes a notice to each respondent bank that it has executed such a proxy. (14b-2(b))

    d. Within 5 business days following receipt of the proxy, proxy soliciting material and/or annual report, the bank forwards to each beneficial owner on whose behalf it holds securities:
       - Either a properly executed proxy or a request for voting instructions.
       - Other proxy soliciting material and/or annual report. (14b-2(c))

    NOTE: The bank may be operating pursuant to alternative procedures to the omnibus proxy or for securing voting information from beneficial owners if they applied to the Commission for an exception. (14b-2(c))

14. Determine whether the bank designated an intermediary to provide lists of beneficial owners to registrants.

    NOTE: The New York Stock Exchange has designated the Independent Election Corporation of America to act as a intermediary.

15. With regard to fees and expenses, assess whether:

    a. The issuer provided the bank with assurance of reimbursement of the bank's reasonable expenses (direct and indirect) incurred in connection with performing its obligations.

    b. The bank determined that its expenses are reasonable within the limitations of the regulation.

Securities Activities

16. If the bank employs specialists for effecting securities transactions (trading personnel), determine if:
    a. Their duties are described in writing.
    b. The bank has established policies and controls to preclude them from participating in or dealing with:
    - Account management.
    - Account ledgers.
    - Securities handling or control.
    - Reconciliation of written broker's confirmations to transaction records.

    c. The bank has established their competency in the following areas:
    - Knowledge of securities laws.
    - Knowledge of securities markets and broker/dealers best suited for individual transactions to obtain the best execution for accounts.
    - Combining orders for the same security received from more than one account in the same time frame.
    - Efficient handling of block trades.
    - Use of available communications facilities such as direct lines and automated facilities (e.g., Autex and Instinet).

17. In the processing of securities transactions, review and verify whether the bank's procedures require that:
    a. Instructions to buy and/or sell originate with account managers to preclude the traders from taking a position in a security without prior orders.
    b. The instructions:
    - Be in writing.
    - Indicate date and time forwarded to the trader.
    - Include information pertaining to:
      —Accounts for which the order is to be executed.
      —Directions, requests, recommendations or approvals.
      —Market or limit orders.
      —Broker selection.
      —Any other special instructions.
    - Be properly identifiable by signature of authorized party, regardless of whether they are original instructions or confirmations of telephoned instructions from the account manager.

    c. Traders use the following records:
    - Pre-numbered memoranda or tickets.
    - Permanent records of transactions, such as blotters, logs or tickets bound together in chronological sequence.

    d. Traders include information such as the following in recording activities on both individual orders and permanent records of transactions:
    - Date and time of:
      —Receipt of the order.
      —Execution of the order.
    - Settlement date.
    - Price at execution.
    - Commission or other type of compensation agreed upon, e.g., negotiated rate or net trade.

    e. Parties independent of account managers and traders perform the following:
    - Reconcile confirmations from brokers and dealers to the instructions and traders' memoranda.
    - Post account ledgers.
    - Keep a record of unexecuted orders.
    - Follow up unexecuted orders within 48 hours after placement with broker.

18. If the bank combines purchase or sale orders of the same security for more than one account, ascertain whether:
    a. The resulting benefits in price and broker/dealer charges are applied on a pro rata or average basis to the accounts involved in the transaction.
    b. The bank prorates to each account its allocable share of the securities purchased or sold, if the entire order cannot be executed.

19. If the bank does not combine purchase or sale orders of the same security, ascertain that transactions are made on a first-in, first-out basis.

20. Determine if the bank notifies customers of information concerning securities transactions, within 5 business days of the date of the transaction, by one of the following methods unless acceptable alternative procedures have been adopted: (12 CFR 12.4 and 12.5)
    a. A copy of the broker's confirmation and a statement of the source and amount of any remuneration to be received by the bank in connection with the transaction. (12 CFR 12.4(a)(1))
    b. Another type of written notification chosen by the bank disclosing the:
    - Name of the bank and the capacity in which it is acting. (12 CFR 12.4(b)(1) and (3))
    - Name of the customer. (12 CFR 12.4(b)(2))
    - Date of execution and a statement that the time of execution will be furnished within a reasonable time upon request. (12 CFR 12.4(b)(4))
    - Name of broker/dealer used and amount of any commissions to be received by them in

connection with the transaction. (12 CFR 12.4(b)(7))

- Source and amount of any remuneration to be received by the bank in connection with the transaction. (12 CFR 12.4(b)(6))

21. Determine that the bank, when effecting securities transactions for customers, maintains records of such transactions by: (12 CFR 12.3)
    a. Keeping an itemized daily record of all purchases and sales of securities which states the account or customer, a description of the securities, the unit and total purchase or sales price, the trade date and the name of the broker/dealer or person from whom purchased or to whom sold. (12 CFR 12.3(a))
    b. Keeping customer records reflecting all purchases and sales of securities, receipts and deliveries of securities, and all receipts and disbursements of cash for transactions in securities for such customer. (12 CFR 12.3(b))
    c. Keeping a separate detailed order ticket, whether executed or cancelled, which includes: (12 CFR 12.3(c))
        - Account(s) name.
        - Whether the transaction was a market order, limit order, or subject to special instructions.
        - Time order received by a person responsible for effecting the transaction.
        - Time order placed with broker/dealer, executed or cancelled.
        - The price at which the order was executed.
        - The broker/dealer used.
    d. Recording all broker/dealers selected and the amount of commission paid or allocated to each during the calendar year. (12 CFR 12.3(d))

22. Determine if the bank has written policies and procedures governing:
    a. Supervision of traders or those who transmit or execute transactions in securities for customers. (12 CFR 12.6(a))
    b. Fair and equitable allocations of securities and prices when transactions in the same security are received and executed at approximately the same time. (12 CFR 12.6(b))
    c. The crossing of buy and sell orders on a fair and equitable basis. (12 CFR 12.6(c))
    d. Bank officers and employees reporting, within 10 days after the end of the calendar quarter, all securities transactions made by them or on their behalf. (12 CFR 12.6(d))

23. Proceed to step 23 of Tier I.

The objectives of these procedures are to evaluate the scope and adequacy of the audit coverage for fiduciary activities; the qualifications of the internal/external auditors; the degree of independence exercised by the auditing personnel; and whether the directors' audit committee is fulfilling its responsibility as required by 12 CFR 9.9. An effective, comprehensive audit program is essential to ensuring compliance. Thus, the following procedures are important to the OCC's compliance examination approach.

Tier I

PROCEDURES

1. Assess the extent of audit committee supervision by determining whether: (12 CFR 9.9)
   a. A trust audit committee has been formed and made responsible for auditing the bank's fiduciary activities. (DS VII-15)
   b. The members of the trust audit committee do not include active officers of the bank or members of other committees involved with fiduciary activities.
   c. The audit program and schedule have been formally approved by the audit committee.
   d. The auditor reports to the board or audit committee.
   e. Audit reports are required to be timely and sufficiently detailed to accurately present to the audit committee the work performed and the basis of findings.

For Internal Auditors: (including holding company auditors)

2. Review and evaluate the educational background and training of the internal auditor.
3. Assess the independence of the auditor by:
   a. Determining if the personnel assigned to perform the internal audit have no other duties or relationships that conflict with internal audit review functions and responsibilities.
   b. Determining if any restrictions have been placed on the audit program.
   c. Determining whether the internal auditors are free from the influence of management, including performance evaluation and control of salaries.
   d. Reviewing the distribution of internal audit reports.
4. Evaluate the scope of the auditor's work by reviewing the bank's written audit reports and working papers for adequacy. For assistance, use the Audit Function Questionnaire. (DS VII-12, 13)

For External Auditors—CPAs and Non-CPAs

5. Review the auditor's engagement letters and note any restrictions or critical comments.
6. Review and evaluate the educational background of and training for non-CPA external auditors.
7. Assess the independence of the auditor by:
   a. Determining if the auditors have any relationships with the bank, its directors, officers, employees, or other material involvements with or as shareholders or significant unsecured borrowers that would compromise their independence.
   b. Determining if the auditors have stock holdings or borrowings with the bank.
8. Evaluate the scope of the auditor's work by reviewing the audit reports. For non-CPAs, also review supporting workpapers. For assistance, use the Audit Function Questionnaire. (DS VII-12, 13)

General

9. Determine whether the audit committee has: (12 CFR 9.9)
   a. Audited, either directly or through others, the bank's fiduciary activities at least once each calendar year and within 15 months of the preceding audit.
   b. Concluded that the bank conducts its fiduciary activities in accordance with law, 12 CFR 9, and sound fiduciary principles, and reported this conclusion to the board.
   c. Reviewed comments about fiduciary activities in the most recent OCC report of supervisory examination and taken appropriate corrective actions.
10. Discuss the following with management:
    a. Violations of law, rulings, regulations or significant internal control deficiencies, emphasizing particularly their causes.
    b. Recommended corrective action for deficiencies cited.
    c. Bank's commitment to specific actions for correcting deficiencies.
11. Summarize your conclusions concerning the bank's internal/external audit functions. This summary should focus on:
    - Material policy deficiencies.
    - Material internal control weaknesses.
    - Violations of laws, rulings and regulations.
12. Update appropriate work programs.

AUDIT FUNCTION QUESTIONNAIRE

Review auditors' reports, appropriate programs and working papers to answer the following audit function questions. When appropriate, retain or note supporting documentation and pertinent information.

Determine whether the internal or external auditor, during each calendar year and within 15 months of the last such audit, has performed the following procedures. Procedures identified with an asterisk (*) are mandatory as noted in Section 401.1 of the *Comptroller's Handbook for National Trust Examiners*. All other applicable procedures should be performed unless an appropriate risk analysis program supports omitting the procedures. Other procedures not listed (e.g., securities lending and discount brokerage activities, repurchase and reverse repurchase agreements and oil, and gas and mineral interests) should be performed if warranted by analyzing the risk in each area.

ACCOUNTING AND PHYSICAL SECURITY CONTROLS

Has the auditor:

1.* Verified all account assets annually or as otherwise approved by the OCC using statistical sampling or 36-month verification procedures? Asset verification should include a confirmation from holders of assets retained outside the bank.

2.* Determined whether assets are safeguarded adequately and held separate from bank assets? This includes unissued stock and/or bond certificates and unissued checks.

3.* Verified that a vault record of assets under joint custody is maintained in the form of a bound book or ticket system?

4.* Determined whether bank securities pledged under 12 CFR 9.10(b) and 12 CFR 9.14 are adequate, properly safeguarded, held separate from bank assets, and earmarked appropriately on book entry systems?

5.* Using appropriate sampling techniques, verified prompt ledger control of assets, including worthless assets, received as original and subsequent deposits, including stock splits and stock dividends?

6.* Verified that fiduciary cash accounts are reconciled regularly with the demand deposit account statement(s)?

7.* Verified that internal balancing control procedures are appropriately performed each time ledgers are posted?

8.* Verified that all suspense or operating accounts are reconciled at least monthly, contain only appropriate items, and are cleared in a timely manner?

9.* Reconciled or verified for non-automated systems the proper reconcilement of each of the following to the trust department general ledger controls at least quarterly.

   a. Income cash?
   b. Principal cash?
   c. Invested income?
   d. Invested principal?
   e. Each type of investment, such as stock, bonds, real estate loans and real estate?
   f. Investments by issuer?

10.* Reconciled or verified the reconcilement by others of bonds printed to the printer's certificate for each bond trusteeship at least once in each calendar year?

11.* Using appropriate sampling techniques, verified the accurate payment of dividends from dividend disbursing agency accounts by reconciling or verifying the bank's reconciliation?

12. Using appropriate sampling techniques, reconciled or verified the bank's reconcilement of bond closing statements of new corporate bond trusteeships to trustee records? Reconcilements should include trustee records of bonds authenticated and issued, proceeds from bond sales, and initial funding of related accounts.

13. Using appropriate sampling techniques, verified the accuracy of payments from paying agency accounts by reconciling or verifying the bank's reconciliation?

14. Determined the adequacy of the bookkeeping system for the volume and nature of business transacted?

ACTIVITY CONTROL

Using appropriate sampling techniques, has the auditor:

15.* Verified commissions and fees paid to the bank?

16.* Verified proceeds from sales of assets to brokers' invoices, purchasers' receipts, or other evidence of sales price?

17.* Verified payment for purchases of assets to brokers' invoices, sellers' receipts or other evidence of purchase price?

18.* Verified accuracy of amounts and receipt of income from investments?

19. Verified distributions of income and principal for accuracy, conformity with terms of governing instruments, and receipts by distributees?

20. Verified payments for services, such as brokerage fees, real estate management and maintenance charges and similar disbursements? All payments must be supported by appropriate bills or invoices.

21. Verified that combined securities transactions re-

sult in equitable distributions in the price and commission among accounts?

22. Verified that securities transactions are reconciled by an independent party with the trader's memo and broker's confirmation by price and commission for each security transaction?
23. Verified that securities transactions are completed within acceptable time limits?

COMPLIANCE

Has the auditor:

24.* Verified that transactions between fiduciary accounts and directors, officers or employees of the bank, its holding company, other affiliates or interests of such persons are in compliance with 12 CFR 9.12?

25.* Reviewed fiduciary account holdings of the following for compliance with 12 CFR 9.12:

  a. Stock, obligations, repurchase agreements, savings and other time accounts of the bank, its affiliates or other organizations in which there exists such an interest as might affect the exercise of the best judgment of the bank?

  b. Obligations of directors, officers and employees of the bank, its holding company or its affiliates or other individuals with whom there exists such a connection as might affect the exercise of the best judgment of the bank?

26.* Verified that accounts for which the bank has investment responsibilities are reviewed in accordance with 12 CFR 9.7?

27.* Verified that cash receipts are invested or distributed promptly in compliance with 12 CFR 9.10?

28.* Performed (for registered transfer agents) an annual study and evaluation of internal accounting controls in compliance with 17 CFR 240.17Ad-13? This requirement does not apply to exempt or non-registered transfer agents.

29.* Performed or verified the performance of an annual audit of each collective investment fund in compliance with 12 CFR 9.18(b)(5)?

30.* Checked for compliance with 31 CFR 103 (Currency and Foreign Transactions Reporting Regulation)?

31. Determined that products and services purchased with securities brokerage commissions are within the "safe harbor" provision of Section 28(e) of the Securities Exchange Act of 1934 or that the bank makes full disclosure to appropriate parties regarding the purchase of such services? (TBC-25).

32. Reviewed overdrafts to determine the amounts, cause, duration, anticipated date of elimination, and adequacy of security?

33. Evaluated the allocation of income and principal for compliance with local law?

34. Tested documents necessary for closing accounts, such as discharges, releases, receipts and accountings?

35. Assessed the propriety of the amount of cash held in and supporting documentation for time deposit open accounts (non-interest bearing)?

36. Reviewed written policies and procedures and related reports of securities transactions by or on the behalf of bank officers or employees "who make investment recommendations or decisions for the accounts of customers, who in the determination of such recommendations or decisions, or who, in connection with their duties, obtain information concerning which securities are being purchased or sold or recommended for such action . . ."? (12 CFR 12.6(d))

37. Tested for compliance with local escheat laws?

38. Determined whether real estate is properly insured, subject to periodic appraisals and inspections that are adequately documented and, when appropriate, produce income?

39. Determined that supporting papers for real estate loans and contracts are appropriate and correct?

ADMINISTRATIVE AUDITS

Determine whether the auditor, using appropriate sampling techniques, completed administrative audits of all major account types, including, but not limited to, personal trusts, estates, corporate trusts, pension trusts and profit-sharing trusts. Activity in each account should be reviewed for the time period selected and spot checked or verified in detail to satisfy audit objectives. To conform with 12 CFR 9.9, an administrative audit of fiduciary activities must include the following mandatory procedures 40-43. Has the auditor:

40.* Determined whether the original or an authenticated copy of the governing instrument is on file?

41.* Determined if synoptic and history records are reliable and comprehensive?

42.* Determined whether accounts are administered and invested in conformance with management policies, governing instruments, laws, regulations and sound fiduciary principles?

43.* Determined if minutes of the board of directors or designated persons and committees document the review of important matters, such as the acceptance and closing of accounts, review and disposition of investment and discretionary payments of principal or income?

44. Determined whether excessive trading is not practiced in managed portfolios?

45. Determined whether written approvals or directions of appropriate parties are obtained promptly?
46. Determined if tax returns are prepared and are filed on time with proper remittances?
47. Tested the accuracy of account statements submitted to beneficiaries and others?

The majority of assets held by bank fiduciaries are marketable securities, i.e., securities in active trading markets where they may be converted readily into cash. Generally, significant amounts of monies are invested by bank fiduciaries in such securities, representing a high level of risk. As a result, all examination procedures for this section are in Tier I.

The objectives of these procedures are to determine the adequacy of the bank's policies, procedures, and practices as they relate to the investment decision making process, and the overall quality of marketable securities held in fiduciary accounts where the bank has investment responsibility. This evaluation should include the review of:

- The process by which investment decisions are exercised.
- Investment quality standards used to select marketable securities.
- Source and quality of investment research material, either in-house or from external sources.
- Procedures to monitor and evaluate asset quality.

In performing these procedures, the examiner should focus on the effectiveness of the internal control systems implemented by the bank to ensure compliance. The extent of the testing should be based on work performed by internal/external auditors and/or other internal compliance review units and formalized policies and procedures, and the effectiveness of management information systems.

For substantial deficiencies disclosed in audit/compliance reports, determine whether corrective action has been taken or if not, why not.

Tier I

PROCEDURES

1. Evaluate the soundness of the bank's investment practices in selecting, retaining, and disposing of marketable securities. Consider the volume and nature of the bank's investment activity when evaluating investment practices. (12 CFR 9.11)
2. Evaluate the adequacy of investment research material used by the bank. The bank should consider information concerning world, national and local economic conditions when selecting investments.
3. Determine whether securities by issuer are reviewed annually and appropriately documented. (12 CFR 9.7(a)(2))
4. If the bank uses approved lists of securities for the purchase, retention or sale of assets, determine if:
   a. Additions to or deletions from the approved list are reviewed and approved by a committee or an authorized person.
   b. Purchases and sales of securities for accounts where the bank has investment responsibility are made in accordance with the approved list.
   c. Purchases and sales of securities are monitored for compliance with the approved list.
   d. The reasons for retention of securities not on the approved list are documented.
5. Analyze the quality of the marketable securities portfolio by selecting a sample of securities from one or more of the following sources:
   - The bank's property master list.
   - Form 13F and schedules 13D and 13G, as applicable.
   - The bank's management information systems for portfolio holdings.
   - The bank's itemized daily record of purchases.
   - Account asset holders list.
6. Rate all selected securities (from step 5) according to an acceptable rating service, such as Standard & Poor's or Moody's. The following guidelines can be used to detect marginal, substandard or speculative securities that may require further analysis. Securities with the following ratings require no further action:
   - Common stock rated B+ or higher by Standard & Poor's.
   - Preferred stock rated A or higher by Standard & Poor's.
   - Debt securities rated A or higher by Standard & Poor's or Moody's.
   - Industrial revenue bonds rated A or higher by Standard & Poor's or Moody's.
   - Convertible debentures rated A or higher by Standard & Poor's (if rated lower or not rated, ratings of B+ or higher for common stocks and A or higher for senior debt would be considered acceptable quality).
   - Commercial paper rated A-1 or 2 by Standard & Poor's or P-1 or 2 by Moody's.
   - Variable amount notes of borrowers of prime credit.
7. For securities falling below the guidelines noted in step 6, determine the aggregate dollar amount of such holdings for accounts where the bank has investment responsibility.
8. Select significant holdings of securities from step 7, and ensure that the bank has research material on file to document their selection and retention. This material should include:
   - An appraisal of the company's management.
   - A study of the company's financial condition and position in its industry.
   - Ratios of balance sheet and operating data used to determine the company's quality of earnings and historical growth.

9. For any securities that are not considered suitable for accounts with investment responsibility (based on a lack of research material or material weaknesses noted in the research material), discuss with management its views on retention of such investments and the investment decision making process used.
10. Discuss the following with management:
    a. Violations of law, rulings, regulations or significant internal control deficiencies, emphasizing particularly their causes.
    b. Recommended corrective action for deficiencies cited.
    c. Bank's commitment to specific actions for correcting deficiencies.
11. Summarize your conclusions about the bank's investment practices and procedures relating to marketable securities. This summary should focus on:
    - Material policy deficiencies
    - Material internal control weaknesses.
    - Violations of laws, rulings and regulations.
12. Update appropriate work programs.

The objectives of these procedures are to determine the adequacy of the bank's policies, procedures, and internal controls as they relate to the management of asset holdings of the following types. The term "other assets" refers generally to assets that are not actively or readily converted into cash, such as those in the marketable securities area. Those assets are used less often as fiduciary investment vehicles. They are:

- Real estate.
- Real estate loans.
- Closely held companies.
- Mineral interests.
- Miscellaneous assets.

In performing these procedures, the examiner should focus on the effectiveness of the internal control systems implemented by the bank to ensure compliance. The extent of the testing should be based on work performed by internal/external auditors and/or other internal compliance review units and formalized policies and procedures, and the effectiveness of management information systems.

Tier I

PROCEDURES

1. Review the bank's investment policies, procedures and internal controls and determine if:
    a. Investment management guidelines exist for the acquisition and retention of other assets.
    b. Such holdings are reviewed and evaluated periodically in terms of suitability for accounts holding such assets. (12 CFR 9.7(a)(2))
2. Select other asset type(s) that meet any of the following criteria:
    a. Holdings constitute a significant investment in relationship to the bank's overall fiduciary asset position.
    b. The asset type is a new form of investment not previously held by the bank or trends indicate its greater future use as an investment vehicle.
    c. Deficiencies were disclosed at the previous OCC on-site review or through internal sources.
    d. Inadequate policies or procedures are in effect for the management of the asset type.
3. For the other asset types identified in step 2 of this program (held for accounts with investment responsibility), perform the necessary testing called for in Tier II. If no asset type meets the criteria in step 2, do not proceed to Tier II.
4. Discuss the following with management:
    a. Violations of law, rulings, regulations or significant internal control deficiencies, emphasizing particularly their causes.
    b. Recommended corrective action for deficiencies cited.
    c. Bank's commitment to specific actions for correcting deficiencies.
5. For deficiencies noted in any procedures, prepare a summary of your conclusions. This summary should focus on:
    - Material policy deficiencies.
    - Material internal control weaknesses.
    - Violations of laws, rulings and regulations.
6. Update appropriate work programs.

Tier II

PROCEDURES

Closely Held Companies

1. Test for compliance with policies, procedures, and internal controls in conjunction with the following examination procedures:
    a. Obtain from the bank a list of investments in closely held companies, including corporations, partnerships, and proprietorships in accounts for which the bank has investment responsibility.
    b. Apply appropriate sampling techniques to the list to select specific investments in closely held companies for review.
2. Inspect bank files to determine if: (12 CFR 9.7(a)(2))
    a. Annual financial statements and other appropriate financial data of the company are on file.
    b. The company's financial condition and results of operations are reviewed at least annually.
    c. The current status of the industry in which the company operates is reviewed.
3. Review financial and other documentation available to ascertain whether the bank performs satisfactory analyses when it considers the appropriateness of retention, sale, liquidation or other disposition of closely held company investments. (12 CFR 9.7(a)(2))
4. When bank personnel represent the interests of the beneficiaries and the bank on the board of directors of a closely held company, determine whether the bank considers the prudence of:
    a. Protecting them from liability for their actions as directors by maintaining appropriate insurance coverage.
    b. Barring them from receiving a director's fee or other compensation from the company for their personal benefit. (12 CFR 9.12)

c. Prohibiting them from acquiring an interest, financial or otherwise, in the company other than representing the beneficiaries and the bank. (12 CFR 9.12)

5. Determine that, when appropriate, bank practices include:
   a. Attending stockholders' meetings of companies, particularly of those having problems.
   b. Exercising control over the management of companies in which it has sole or majority voting control.
   c. Determining the ownership of other interests, if the bank holds a minority interest, to effect joint control over management of the company for the best interests of beneficiaries.
   e. Encouraging incorporation of general partnerships and proprietorships, where feasible.
   f. Attempting to sell the business as a going concern when it is considered to be in the best interest of beneficiaries.

6. For any deficiencies noted, see steps 4 and 5 of Tier I.

Real Estate Loans

7. Test for compliance with policies, procedures, and internal controls. Using appropriate sampling techniques, select outstanding real estate loans in accounts with investment responsibility.

8. Review selected loans to ensure that in the administration of real estate loans, the following bank practices are observed:
   a. Leases of single purpose commercial properties are made to creditworthy lessees, and rentals will liquidate the loan at maturity. Financial statements of the lessees and financial rating services can be reviewed.
   b. When required, the bank obtains:
      - Corporate resolutions.
      - Valid certificates of insurance for FHA loans and VA guarantees for VA loans.
      - Reappraisals upon extension of maturity or other modification of such loans.
   c. Appraisals are performed by competent appraisers to determine real estate values.
   d. The ratio of loan to appraised value of real estate security is prudent.
   e. The ability of the borrower to pay is evaluated.
   f. The documentation necessary to establish priority of lien and legality and validity of loan is on file.
   g. The appropriateness of types and amounts of insurance is determined.
   h. The adequacy of interest rates charged is evaluated.
   i. Real estate loans are approved by the board of directors, a committee or a qualified and/or authorized individual. (12 CFR 9.7(a)(1))
   j. The condition of the underlying real property securing delinquent loans is determined at least periodically. (12 CFR 9.7(a)(2))
   k. The bank determines that it, as fiduciary, can enforce foreclosure of a loan secured by real estate in another state.
   l. The board of directors, a committee, or authorized person approves the partial releases of real estate security.

9. For participation mortgages, determine whether the bank:
   a. Keeps records of the aggregate outstanding balance of loans held by all participants as well as the amount allocated to each participating account.
   b. Ensures that participation agreements entered into by the bank provide that each account bears only its pro rata share of loss, in the event of a default.

10. If loan servicing agents are employed, determine whether the bank ascertains that agency agreements include:
    a. Duties and responsibilities of the servicing agent.
    b. Procedures to be used for verification of assets and supporting loan documentation.
    c. Settlement dates for remittance by agent to the bank.

11. Determine whether the bank uses the following procedures for past due loans:
    a. A follow-up program for collection.
    b. Periodic reporting of delinquencies to the board of directors or a committee.
    c. Observing state statutes of limitations when necessary to preserve collectability.

12. Determine whether the bank's procedures provide for monitoring the following by reference to checklists and ticklers:
    a. Compliance with covenants of loan agreements.
    b. Dates for the payment of loans, taxes and insurance premiums.

13. For any deficiencies noted, see steps 4 and 5 of Tier I.

Real Estate [illegible]

14. Test for compliance with policies, procedures, and internal controls in conjunction with the following examination procedures. Apply appropriate sampling techniques to real estate held in accounts with investment responsibility.

15. For selected real property investments, inspect documents, minutes and memoranda to determine if relevant factors are considered when acquiring or retaining the property. Consider the following:
    a. Condition of the title.
    b. Current appraisal by a qualified appraiser.
    c. When necessary, inspection reports by qualified engineers and other specialists for possible structural defects.
    d. Current yield of income producing property.
    e. Income and expense records.
    f. Leases and rents, including status of delinquent rents.
    g. Cost of maintenance and repairs.
    h. Cost of capital improvements.
    i. Condition and value of properties as reflected in annual inspection and triennial appraisals.
    j. Whether real properties are insured appropriately.
    k. If the payment of real estate taxes is monitored to ensure timely payment.
16. Determine whether the bank ascertains from attorneys' opinions, owners' title guaranty policies or other forms of title searches, the condition of the title to real property under administration in accounts with investment responsibility, unless it is otherwise exempt from doing so by the terms of the governing instrument, local law or parties empowered to direct.
17. Determine whether the bank considers the following when selling real estate:
    a. Current appraisals by competent appraisers.
    b. Comparable sales analysis.
    c. Use of multiple listings, when appropriate.
18. If a management agent is employed, determine whether the agency agreement:
    a. Establishes the agent's duties and responsibilities, frequency of reporting, and commission charges.
    b. Has been reviewed by bank legal counsel.
19. For the administration and operation of agricultural, ranch and other non-urban properties, determine whether the bank:
    a. Uses qualified bank personnel or independent agents to manage and/or administer the properties.
    b. Has operating tenant agreements reviewed by bank counsel, when tenant operators are engaged to operate the properties.
20. Determine whether the bank has procedures for verifying the amount of farm commodities, such as grain and tobacco stored in elevators or warehouses, by inspecting warehouse receipts.
21. For any deficiencies noted, see steps 4 and 5 of Tier I.

Mineral Interests

22. Test for compliance with policies, procedures, and internal controls in conjunction with the following examination procedures. Apply appropriate sampling techniques to mineral interests held in accounts with investment responsibility.
23. For selected investments that have been acquired since the previous examination, review appropriate documentation and determine whether:
    a. The governing instrument contains appropriate investment and retention provisions. (12 CFR 9.11)
    b. The bank has obtained evidence of title, including:
        - Deed, division order or assignment.
        - An attorney's opinion when title validity is in question.
        - Title insurance.
    c. The bank employs outside personnel or consultants who are knowledgeable in the administration of mineral interests when in-house expertise is unavailable.
    d. The bank has obtained adequate documentation for working interests, including:
        - Operating agreements.
        - Liability and property insurance, if necessary.
24. When working interests are involved, determine if the bank:
    a. Analyzes and approves all authorizations for expenditures.
    b. Reviews each working interest for profitability.
25. Determine whether the bank has an adequate accounting system for oil, gas and other mineral interests.
26. Ascertain if the bank maintains a tickler system for:
    a. Delay rentals on non-producing interests.
    b. Covering important events.
    c. Unleased interests.
    d. Lease and royalty payments.
27. When leasing mineral interests, determine whether the bank uses appropriate forms, such as one of the following:
    a. A special lease prepared by the bank and/or bank's counsel.
    b. A standard industry lease.
    c. A lease prepared by the leasing company.
28. Determine that the bank has mineral lease agreements reviewed by bank counsel and an appropriate committee before being executed.

29. Determine whether the bank has guidelines to avoid leasing to bank insiders or their related interests. (12 CFR 9.12)
30. Select for review mineral interests which have been sold since the previous examination and determine if such sales are supported by:
    a. Authority to sell in the governing instrument. (12 CFR 9.11)
    b. Adequate current appraisals.
    c. Comparisons, when possible, with other sales in the area.
31. Determine whether the bank qualifies, when possible, to operate as a fiduciary in another state for purposes of holding title to mineral interests in that state. If not, determine if the bank hires a party from that state (e.g., ancillary trustee) to hold title to the mineral interests subject to its direction.
32. Determine whether the bank has a system for filing all oil, gas, and mineral interest papers and data necessary to maintain a complete historical record.
33. For any deficiencies noted, see steps 4 and 5 of Tier I.

Miscellaneous Assets

34. Test for compliance with policies, procedures and internal controls in conjunction with the following examination procedures. Obtain a list of the following investments held in accounts with investment responsibility. Apply appropriate sampling techniques to the list to select investments for review.
    a. Restricted securities, such as investment letter stock and control stock. (17 CFR 230.144)
    b. Stock options. (TBC-2 (Rev))
    c. Private placements.
    d. Mutual funds. (TBC-4 (Rev))
    e. Art, coins, bullion or stamps.
    f. Repurchase agreements. (TBC-22)
    g. Forward contracts and financial futures. (TBC-14 (Rev))
35. Ascertain that the bank has not invested or otherwise dealt in the selected securities unless authorized by the governing instrument, local law, or the written consent of beneficiaries. (12 CFR 9.11)
36. For securities subject to trading restrictions, options or repurchase agreements, verify that the bank. (17 CFR 230.144) (TBC-2 (Rev)) (TBC-22)
    a. Earmarks such securities on account ledgers so that they can be identified readily.
    b. Controls or lists such securities so that they and/or the accounts holding them can be monitored readily.
37. If the governing instrument authorizes or directs investment in or retention of restricted securities, determine: (12 CFR 9.11)
    a. Whether the issuer's publicly traded securities of the same type, (i.e., common stocks and bonds) are of investment quality.
    b. If the bank is in compliance with SEC Rule 144. (17 CFR 230.144)
38. If the trust department invests in reverse repurchase agreements, determine whether written policies: (TBC-22)
    a. Limit the maximum amount of funds to be extended to any single or related borrower through reverse repurchase agreements.
    b. Require firms involved in reverse repurchase agreements to submit corporate resolutions stating the names and limits of individuals who are authorized to commit the borrower.
    c. Require submission of current financial information by borrowers involved in reverse repurchase agreements.
    d. Provide for periodic credit reviews and approvals for borrowers involved in reverse repurchase agreements.
    e. Specify types of acceptable collateral for reverse repurchase agreements.
    f. Specify that funds are not disbursed until collateral is delivered into the physical custody of the bank as trustee or to an independent safekeeping agent.
    g. Specify that funds are advanced only against predetermined collateral margins or discounts.
    h. Specify that collateral margins or discounts are predicated upon:
        - The type of security pledged as collateral.
        - The quality and maturity of the collateral.
        - Price volatility of collateral.
        - Maturity of the reverse repurchase agreements.
39. Determine if the bank's fiduciary accounting records reflect: (TBC-22)
    a. Complete and accurate descriptions of all repurchase agreement transactions.
    b. The amount and maturity date for all outstanding repurchase agreements on individual account asset listings.
40. Determine whether the bank determines that shares of investment companies must not be purchased or retained unless they are: (TBC-4 (Rev))
    a. Analyzed for performance by comparison with other funds (e.g., growth, income, or balanced funds).
    b. Appropriate for the account.
41. If investments in private placements are held, determine if the bank considers their suitability by

analyzing them and referring to factors listed in the *Comptroller's Handbook for National Trust Examiners*.

42. When making any non-real estate loans, ascertain whether the bank considers:
    a. The characteristics of the loan being made.
    b. The amount of investment in non-real estate loans.
    c. Appropriate documentation.

43. If fiduciary accounts are invested in Small Business Administration loans, ascertain whether the bank determines that the investments:
    a. Are only in the guaranteed portion of the loan.
    b. Fit the needs of the fiduciary account.
    c. Are not prohibited by the terms of the governing instrument or local law.
    d. Are to be repaid first to the fiduciary account or at least on an equal basis with the banking department.

44. Determine that the bank has procedures for follow-up of past due loans.

45. Determine whether the bank's policies permit investments in forward contracts and financial futures for accounts with investment responsibility only when: (TBC-14 (Rev))
    a. Authorized by the governing instrument, local law, or account beneficiaries.
    b. The bank has adopted specific written policies outlining permissible futures contracts and forward strategies and their relationship to general investment strategies.
    c. The bank has established a system to ensure that forwards and futures contracts are reviewed and valued regularly at market value.
    d. Accounting records adequately identify:
        - The type and amount of each contract.
        - The maturity date of each contract.
        - The current market price and cost of each contract.
        - The amount of money held in margin accounts.

46. For any deficiencies noted, see steps 4 and 5 of Tier 1.

The objective of these procedures is to determine whether the collective investment of fiduciary funds is being properly operated. Collective investment funds (CIFs) are a major investment vehicle utilized by banks to manage fiduciary accounts. Generally, a high ratio of managed assets is concentrated in such funds, posing significant risks to the bank. For these reasons, all examination procedures for this section have been placed in Tier I. The bank should establish internal controls that adequately address the proper administration of collective investment funds. They should include:

- When required, a written plan of operation.
- A determination of fund eligibility for accounts.
- Records that appropriately reflect the interests of participating accounts and CIF investments.
- An adequate audit of CIFs.
- Monitoring procedures to ensure compliance with 12 CFR 9.18 and applicable federal and local laws governing the operation of CIFs.

When evaluating this area, the examiner should focus on the effectiveness of the internal control systems implemented by the bank to ensure compliance. The extent of the testing should be based on work performed by internal/external auditors and/or other internal compliance review units and formalized policies and procedures, and the effectiveness of management information systems.

For substantial deficiencies disclosed in audit/compliance reports, determine whether corrective action has been taken or if not, why not.

Completion of the Collective Investment Funds Worksheet at the end of this section will assist the examiner in performing these procedures. The worksheet is optional.

Tier I

PROCEDURES

1. For CIFs established or amended since the last onsite review, determine if the plan documents are:
   a. Reviewed by bank counsel and approved by the board of directors or by a committee designated by the board.
   b. Consistent with the provisions of 12 CFR 9.18(b)(1) for those created pursuant to 12 CFR 9.18(a).

   NOTE: The Trust Division no longer routinely reviews CIF plans. Such reviews should be performed by examiners at the time of the trust compliance examination.

2. Review portfolios of CIFs and determine whether assets held conform to provisions of the plan document and investment objectives of the fund.

3. Test CIFs operated under 9.18(a) and determine whether:
   a. All CIFs are valued in accordance with at least the minimum frequency required by the regulation. (12 CFR 9.18(b)(4))
   b. All valuations are completed within prescribed time periods. (12 CFR 9.18(b)(4))
   c. No participation is admitted to or withdrawn from a CIF, except on the basis of the valuation and as of the valuation date. (12 CFR 9.18(b)(4))
   d. No participation is admitted to or withdrawn from a CIF unless a written request for or notice of intention of taking such action was entered, on or before the valuation date, in the bank's fiduciary records. (12 CFR 9.18(b)(4))
   e. No request or notice for admission or withdrawal has been cancelled or countermanded after the valuation date. (12 CFR 9.18(b)(4))
   f. Distributions to withdrawing participants are made in cash or ratably in kind, or partly in cash and partly in kind, provided, that distributions as of any one valuation date, shall be made on the same basis. (12 CFR 9.18(b)(6))
   g. Overdrafts are allowable and temporary. (12 CFR 9.18(b)(8)(i))
   h. The bank does not sell assets to, or purchase assets from, a CIF. (12 CFR 9.18(b)(8)(i)) (12 CFR 9.12)
   i. No assets of a CIF are invested in bank stock or that of its affiliates, or in their obligations, including time deposits, unless the latter comprise funds awaiting investment or distribution. (12 CFR 9.18(b)(8)(i))
   j. No loans are made by the bank on the security of a participation in a CIF. (12 CFR 9.18(b)(8)(i))
   k. The bank does not lend any money to a fund. (12 CFR 9.18(b)(8)(i))
   l. No units of participation in any 9.18(a)(1) fund are held by an agency account.
   m. All participations in 9.18(a)(2) funds by employee benefit accounts are authorized by governing instruments or directed by an empowered fiduciary other than the bank. (ERISA Section 408(b)(8))
   n. If the bank acquires an interest in a participation in a CIF, the participation was or will be withdrawn on the first date such withdrawal can be effected. (12 CFR 9.18(b)(8)(i))
   o. Participations in 9.18(a)(2) funds that obtain tax exemption under Section 584 of the Internal Revenue Code are limited to those accounts exempt from federal income taxation and trusteed by the subject bank.
   p. Participations in 9.18(a)(2) funds that obtain tax exemption under Revenue Ruling 81-100, as amended, are limited to qualified employee

benefit accounts for which the bank acts as trustee or agent.

4. Inspect participants' holdings of CIF units established pursuant to 12 CFR 9.18(a)(1), and ascertain whether: (12 CFR 9.18(b)(9)(i))
    a. Any participant held more than 10 percent of the then market value of the CIF resulting from direct investment. Any such participation should be reduced to 10 percent or less at the next valuation date.
    b. Any participant held more than 15 percent of the market value of the CIF resulting from other than direct investment. Any such participation should be reduced to 10 percent or less within 1 year.
5. Inspect investments held in CIFs established pursuant to 12 CFR 9.18(a)(1) and determine whether:
    a. A holding of stocks, bonds or other obligations, not guaranteed by the U.S. government, of any one entity exceeds 10 percent of the then market value of the CIF as a result of direct investment. Any such holding should be reduced to the 10 percent limit not later than the next valuation date. (12 CFR 9.18 (b)(9)(ii))
    b. A holding of stocks, bonds or other obligations, not guaranteed by the U.S. government, of any one entity exceeds 15 percent of the then market value of the CIF as a result of other than direct investment. Any such holding should be reduced to the 10 percent limit within 1 year. (12 CFR 9.18(b) (9)(ii))
    c. The bank maintains, in cash and readily marketable securities, such percentage of the assets of the fund as is necessary to provide for liquidity needs and to prevent inequities among withdrawing participants. (12 CFR 9.18(b)(9)(iii))
6. Determine whether the bank, in maintaining exclusive management of the CIF, keeps records relating to investment, administrative and operational decisions, including those funds where an investment advisor has been appointed. If an investment advisor places trades, determine if the bank approves trades *prior* to execution. (12 CFR 9.18(b)(12))
7. Inspect participating account files to ascertain that the bank does not issue any certificate or other document evidencing a direct or indirect interest in any CIF. (12 CFR 9.18(b)(13))
8. Determine that the most recent audit of each CIF conforms to regulatory requirements by verifying that: (12 CFR 9.18(b)(5))
    a. Such an audit has been made at least once every 12 months by auditors responsible only to the board of directors.
    b. The CIF is not charged for an audit, unless it is performed by independent public accountants.
9. Determine whether the annual financial report of a CIF contains: (12 CFR 9.18(b)(5)(ii))
    a. A list of investments as of the fiscal year end showing cost and current market value of each investment.
    b. For the period since the last report, a statement showing:
        - Purchases of investments with cost.
        - Sales of investments with profit or loss and any other investment changes.
        - Income and disbursements.
    c. An appropriate notation as to any investments in default.
10. If the annual financial statement includes any comparative performance statistics, determine if such comparisons are only with general market indices. (12 CFR 9.18(b)(5)(iii))
11. Verify that a copy or notice of the availability of the financial report is furnished to each person to whom a regular periodic accounting would ordinarily be rendered. (12 CFR 9.18(b)(5)(iv))
12. Determine whether the bank's advertising practices comply with 12 CFR 9 to the extent that:
    a. The availability of the annual report for funds administered pursuant to Section 9.18(a)(1) is publicized solely in connection with the promotion of bank fiduciary services.
    b. Advertisements of funds administered pursuant to Section 9.18(a)(2) do not contain any misleading statements or otherwise raise a question of violations of SEC anti-fraud rules.
13. Determine whether the bank files:
    a. An informational tax return for CIFs, as required by Section 6032 of the Internal Revenue Code.
    b. The following with the Department of Labor: (29 CFR 2520, Section 103-9)
        - The annual statement of assets and liabilities of the CIF.
        - A list of all plans participating in the CIF that identifies both plans and sponsors.
        - The identification number(s) of the plan(s).
14. Determine whether short-term investment funds are operated in accordance with the following provisions of 12 CFR 9.18(b)(15):
    a. At least 80 percent of the fund is invested in demand obligations or notes, bonds, or indebtedness maturing no longer than 91 days from the date purchased.
    b. The principal is valued at cost and the difference between cost and anticipated receipt on maturity is accrued on a straight-line basis.
    c. Assets usually are held until maturity.
    d. After effecting admissions and withdrawals, not

less than 20 percent of the value of the fund is composed of cash, demand obligations, and assets maturing on the fund's next business day.

15. If any investment of a CIF was segregated, determine whether the investment is being held solely for the ratable benefit of fund participants at the time of segregation. (12 CFR 9.18(b)(7))
16. If a defaulted fixed income obligation has been purchased by the bank from a CIF for its own account, evaluate whether the bank's procedures provide for a determination that: (12 CFR 9.18(b)(8)(ii))
    a. The cost of segregation would have been greater than the difference between its market value and its principal amount plus interest and penalty charges due.
    b. The purchase was made at market value or at the sum of cost, accrued unpaid interest and penalty charges, whichever was greater.
17. Determine that if the bank charges fees directly or indirectly to accounts participating in CIFs, they do not exceed the amount it would charge if the accounts were not participating. (12 CFR 9.18(b)(12))
18. For investments by CIFs in real estate loans, determine if the bank complies with the following requirements of 12 CFR 9.18:
    a. No more than reasonable expenses (which may be charged against the income account of the CIF) were paid to agents for servicing mortgages, including the bank administering CIFs. (12 CFR 9.18(b)(10))
    b. No more than 5 percent of the net income derived from mortgages held by a CIF was transferred to a reserve account during a regular account period and no transfers were made which caused the reserve account to exceed 1 percent of the outstanding principal amount of all mortgages held by the CIF. (12 CFR 9.18(b)(11)(i))
    c. A reserve account, if established, is deducted from the assets of the CIF in determining the unit value at valuation dates. (12 CFR 9.18(b)(11)(i))
    d. Accrued interest in default from mortgages is charged at valuation dates against the reserve account to the extent available, and credited to income distributed to participants. If the amount so charged is recovered, the reserve account is credited with the interest payments received. (12 CFR 9.18(b)(11)(ii))
    e. The value of mortgages is determined at valuation dates on the basis of fair value as determined in good faith and, in the case of FHA and VA mortgages, at quoted market values, where available. (12 CFR 9.18(b)(1))
19. Ascertain that for variable amount notes (VANs): (12 CFR 9.18(c)(2))
    a. Participation records balance with the amount outstanding on the note.
    b. Debit and credit entries are posted immediately to the borrower's deposit account.
    c. The bank or its affiliates do not participate in the loan for their own account.
    d. The bank maintains the note(s) on its premises, unless another location is specifically approved by the OCC.
    e. They are supported by full information on the capital, debt structure and financial condition of the issuer.
20. Ask management to justify the prudence of the following situations that apply to VANs or master notes, if applicable: (12 CFR 9.18(c)(2))
    a. When VANs or master notes total in excess of 10 percent of the market value of total fiduciary assets held as of the previous year end.
    b. When VANs or master notes issued by a single company exceed 5 percent of the market value of total fiduciary assets as of the previous year end.
    c. When VANs or master notes have "A" and "B" components and the "B" portion exceeds 50 percent of the principal amount of the note.
21. When the bank has established special CIFs for particular types of investments, such as covered call options, real estate, real estate mortgages, foreign securities or short-term assets, verify that procedures ensure compliance with OCC rulings and guidelines on:
    a. Eligibility for participation.
    b. Fund valuation.
    c. Liquidity requirements.
22. When applicable, ascertain whether the bank's procedures follow the provisions of the regulation for investing collectively in the following types of CIFs:
    a. Bank fiduciary funds organized and operated pursuant to local statutes (e.g., as in the State of New York). (12 CFR 9.18(c)(1))
    b. A single real estate loan, a direct obligation of the U.S., an obligation fully guaranteed by the U.S. or in a single fixed amount security, obligation or other property, either real, personal or mixed, of a single issuer by two or more accounts. (12 CFR 9.18(c)(2)(i))
    d. A fund for investing cash balances which the bank considers individually to be too small to be invested separately to advantage. (12 CFR 9.18(c)(3))
    e. Any investment specifically authorized by court order or by a governing instrument in the case of trusts created by a corporation, its subsidiaries and affiliates, or by several individual trus-

tors who are closely related. (12 CFR 9.18(c)(4))

   f. In such other manner as has been approved in writing by the Office of the Comptroller of the Currency. (12 CFR 9.18(c)(5))

23. Discuss the following with management:
    a. Violations of law, rulings, regulations or significant internal control deficiencies, emphasizing particularly their causes.
    b. Recommended corrective action for deficiencies cited.
    c. Bank's commitment to specific actions for correcting deficiencies.
24. Summarize your conclusions concerning the bank's operation of collective investment funds. This summary should focus on:
    a. Material policy deficiencies.
    b. Material internal control weaknesses.
    c. Violations of laws, rulings and regulations.
25. Update appropriate work programs.

This worksheet is intended to assist the examiner in performing the Collective Investment Funds procedures. It is optional.

Name of Bank____

Name of Fund__________________________ Type: ____A(1) ____A(2) ____C( )

EXAMINATION DATE			
Number of units			
Market value and valuation date			
Cost at valuation			
Any 10 percent exceptions?			
Any agent accounts?			
Improper investments?			
Borrowings from bank or affiliates?			
REPORTS: Financial report based on an audit?			
Reports or ads make any improper comparisons or guarantees?			
Is notice or copy of report being sent to all required?			
ADMISSIONS AND WITHDRAWALS: Proper requests on file?			
Requests made on or before valuation date?			
GENERAL: All charges to fund proper?			
Any improper advertising?			
Copy of plan available to the public?			

OTHER MATTERS:

The objective of these procedures is to determine the adequacy of the bank's policies, procedures, and systems for managing individual account portfolios. A primary function of a fiduciary is to manage property for others. This section addresses portfolio management practices as applied by the fiduciary in pursuing account investment objectives, individual account needs, terms of governing documents, and acceptable levels of risk and rate of return. Since individual portfolio management is of paramount importance to investment supervision, all relevant examination procedures have been placed in Tier I. In evaluating overall portfolio management practices, consider:

- Identifying individual account objectives and needs.
- Providing for periodic account portfolio reviews.
- Ascertaining investment authority conferred by terms of the governing instrument.
- Exercising reasonable care in selecting, retaining, and disposing of account assets.
- Determining appropriate risk levels for individual account needs and objectives.

When evaluating this section, the examiner should focus on the effectiveness of the internal control systems implemented by the bank to ensure compliance. The testing should be based on work performed by internal/external auditors and/or other internal compliance review units and formalized policies and procedures, and the effectiveness of management information systems.

For substantial deficiencies disclosed in audit/compliance reports, determine whether corrective action has been taken or if not, why not.

Completion of the Portfolio Management Worksheet at the end of this section will assist the examiner in performing these procedures. The worksheet is optional.

Tier I

PROCEDURES

1. Determine whether the bank has adopted procedures that:
   a. Require overall investment policy and potential investment problems to be reviewed at least annually.
   b. Communicate portfolio management policy to appropriate bank personnel, by including it in committee minutes, directives, and memoranda.
   c. Review investment decisions for the purchase or sale of assets to ensure they meet account objectives.
   d. Review the frequency of investment changes to avoid excessive trading practices.
2. Determine if the bank has systems to review account assets in accordance with the regulation: (12 CFR 9.7(a)(2))
   a. Promptly upon the acceptance of each new account for which the bank has investment responsibility.
   b. After the initial review, at least once each calendar year and within 15 months of the previous review for all fiduciary accounts for which the bank has investment responsibility.
3. Determine that applicable minute books or other records:
   a. Identify reviewed accounts.
   b. Contain written conclusions on the advisability of retaining or disposing of assets held in the accounts.
   c. Verify that applicable minute books contain information and reasons for non-execution of approved investment actions.
4. Evaluate account reviews for sufficient documentation, considering:
   a. Synopses of governing instruments.
   b. Account investment objectives.
   c. Background and needs of beneficiaries.
   d. Special reports on real estate, closely held companies and miscellaneous assets.
   e. Approved or guidance lists.
   f. Asset data, including:
      - Categories of investment, such as bonds and stocks.
      - Types of investments within each category, such as industry groups for stocks.
      - The amount and description of each investment.
      - Cost value.
      - Market or appraised value at review date.
      - Annual income.
      - Yield at market.
      - Ratings of recognized financial services (if applicable).
5. Evaluate whether the bank's portfolio management procedures are effective. Select personal fiduciary accounts for which the bank has investment responsibility. To the extent it is feasible, the sample should cover all administrators and administrative units to ensure detection of weaknesses or deficiencies. For accounts selected, determine whether:
   a. Portfolios are invested in accordance with terms of the governing instrument.
   b. Portfolio composition meets account investment objectives and suitability.
   c. Any investment restrictions or unusual provisions are complied with.

d. There have been no transactions involving questions of self-dealing or conflict of interest. (Refer to Conflicts of Interest section for guidance.)

e. Non-income producing assets are appropriate for the investment objectives of the account or are properly authorized.

f. Concentrations in securities of a single entity are properly authorized or retained in accordance with prudent investment standards.

g. Consideration is given to the liquidity needs of an account for anticipated distributions.

h. In accounts where a powerholder other than the bank has the authority to make investment decisions, the bank:
   - Reviews the account to detect illegal, nonconforming, substandard or otherwise unsuitable investments.
   - Advises the powerholder of any impropriety of an investment.
   - Informs parties-in-interest in the account if any improper investment is not disposed of and seeks appropriate relief, if necessary.

6. Review transaction ledgers of sampled accounts to determine whether:
   a. There is evidence of excessive trading by the bank.
   b. Cash balances have been managed efficiently.
7. Discuss the following with management:
   a. Violations of law, rulings, regulations or significant internal control deficiencies, emphasizing particularly their causes.
   b. Recommended corrective action for deficiencies cited.
   c. Bank's commitment to specific actions for correcting deficiencies.
8. Summarize your conclusions about the bank's portfolio management practices and procedures. This summary should focus on:
   - Material policy deficiencies.
   - Material internal control weaknesses.
   - Violations of laws, rulings and regulations.
9. Update appropriate work programs.

This worksheet is intended to assist the examiner in performing the Portfolio Management procedures. It is optional.

Account number____________ Account name____________

Account type____________ Bank's capacity____________ Revocable?____________

Grantor____________ Co-trustee____________

Investment Authority:

PMR____________ Grantor directs____________ Other (specify)____________

Retention Authority:

GPR____________ Specific (describe)____________

Income Distributions:

To whom?____________ How much?____________ How often?____________

Principal distributions:

To whom?____________ Who decides?____________ Other?____________

Emergency provisions? ___ yes ___ no

Spendthrift clause? ___ yes ___ no

Termination: When?____________ To whom does it go?____________

Does the account have a tax #?___

Synopsis sheets used?___

Review date	*Noted in board/trust committee minutes*			*Account officer*
Exam date	*Income cash*	*Prin. cash*	*Invest. prin.*	*Mkt. value & date*

___ *% U.S.* ___ *% Bonds* ___ *% C/Stock (# of issues ___)*

___ *% REM* ___ *% Other (specify)* ___ *% RE*

1. Is the account diversified? ___ yes ___ no (If not, is it prudent for the account not to be diversified? ___ yes ___ no)
2. Do investments meet the needs of the account? ___ yes ___ no
3. Are non-income producing assets reviewed to determine whether to make these assets productive or dispose of them? ___ yes ___ no
4. (For directional trusts) Are any of the assets illegal, nonconforming, or substandard? ___ yes ___ no
5. Are approvals of co-trustees or others on file? ___ yes ___ no
6. Are any exceptions noted in the following areas:
   - Liquidity? ___ yes ___ no
   - Univested cash? ___ yes ___ no
   - Overdrafts? ___ yes ___ no
   - Excessive trading? ___ yes ___ no
   - Purchases not on an approved list? ___ yes ___ no

COMMENTS:

The objective of these procedures is to determine whether the bank is fulfilling its fiduciary responsibilities to personal fiduciary accounts in accordance with the governing document and standards of prudence. It is also important to ascertain whether the bank has established a sound system of controls and administrative policies and procedures to administer personal trust accounts.

When evaluating this section, the examiner should focus on the effectiveness of the internal control systems implemented by the bank to ensure compliance. The testing should be based on work performed by internal/external auditors and/or other internal compliance review units and formalized policies and procedures, and the effectiveness of management information systems.

For substantial deficiencies disclosed in audit/compliance reports, determine whether corrective action has been taken or if not, why not.

Tier I

PROCEDURES

1. Review policies and procedures applicable to personal account administration. Determine if written guidelines are comprehensive and communicated to fiduciary personnel.
2. Review account acceptance procedures to determine if fiduciary accounts are accepted only with the prior written approval of the board of directors or individuals, officers or committees to whom the board has assigned that responsibility after considering whether: (12 CFR 9.7)
   a. The governing instrument presents any problems of interpretation.
   b. The account can be administered to achieve the purpose for which it was established.
   c. Real or potential conflicts exist.
   d. The account will be profitable.
3. Determine that the bank takes proper action to prevent the assumption of liability for acts of the predecessor fiduciary before accepting an appointment as a successor fiduciary.
4. To evaluate the bank's compliance with the terms of governing instruments, the purpose of the account, laws, regulations and sound fiduciary principles, ascertain whether the bank has established:
   a. Checklists for opening and closing accounts.
   b. Synopses of governing instruments, including investment and retention powers, income remittance, dispositive provisions, corpus invasion and other important authorizations.
   c. Records of names of parties-in-interest, co-fiduciaries, and other historical data.
   d. Procedures to ensure that proxies are voted solely in the best interests of the beneficiaries.
   e. Tickler files relating to the preparation and timely execution of future duties, such as:
      - Income remittance.
      - Principal distributions.
      - Insurance expiration.
      - Due date of taxes, bills, etc.
      - Collection of fees.
      - Receipt of dividend, interest and other income.
      - Mailing of account statements.
      - Closing of the account.
   f. Adequate controls for recording account assets and liabilities received outside the operations area.
5. Assess whether the bank receives proper and timely written authorizations from co-fiduciaries or others whose approval or direction is required for important actions.
6. In estates held open for an unusual length of time (3 years or more), determine whether the bank's policies and procedures provide for distributing as many of the assets as possible.
7. Review the adequacy of procedures for filing required tax returns.
8. Review the results of work performed in Tier I. If the results reflect significant violations and/or control deficiencies, or you are unable to reach a conclusion, perform additional procedures, as necessary, in Tier II.
9. Discuss the following with management:
   a. Violations of law, rulings, regulations or significant internal control deficiencies, emphasizing particularly their causes.
   b. Recommended corrective action for deficiencies cited.
   c. Bank's commitment to specific actions for correcting deficiencies.
10. Summarize your conclusions concerning the bank's policies, procedures and practices regarding personal trust administration. This summary should focus on:
    - Material policy deficiencies.
    - Material internal control weaknesses.
    - Violations of laws, rulings and regulations.
11. Update appropriate work programs.

Tier II

PROCEDURES

1. Select a sample of personal accounts, including new accounts, and perform steps 2 through 8 to review for compliance. The sample should include any accounts already examined for portfolio management purposes. To the extent it is feasible, the sample should cover all administrators and administrative units to ensure detection of weaknesses and deficiencies.

2. For personal trusts, estates and agency accounts accepted since the previous examination, determine whether the bank obtains original or authenticated copies of:
   a. Evidence of appointment, such as trust or agency agreements, wills, letters of office from the court, or similar documentation.
   b. Receipts, inventories and appraisals for court accounts, or schedules of assets delivered to the bank or the bank's control for custody and protection.

3. Determine whether the checklists, synopses, ticklers and similar memoranda accurately represent the powers, dispositive provisions and other conditions contained in the governing document?

4. Determine that the bank adheres to local law and/or terms of the governing instruments in allocating cash to income or principal.

5. Determine whether the bank receives proper and timely written authorizations from co-fiduciaries or others whose approval or direction may be required for important actions, such as:
   a. Investment decisions.
   b. Distributions of principal or income.
   c. Employment of outside agents for the management of assets.

6. If the bank acts as co-fiduciary with an individual, determine that it supervises the accounting and management of the account.

7. Determine that the bank files timely accountings with the court or others entitled thereto, such as principals, settlors, trustees and beneficiaries.

8. Review fiduciary tax administration and ensure that:
   a. The proper amount of estimated quarterly taxes is being paid to the IRS.
   b. All taxes owed by estates (federal and state) are paid within the time limits required by the Internal Revenue Code (IRC) and state law.
   c. The following tax returns are filed in a timely manner with the IRS:
      - Form 56 (Notice Concerning Fiduciary Relationships, IRC 6036 and 6903).
      - Form 706 (Federal Estate Tax Return).
      - Form 709 (Gift Tax Generation Skipping Transfer, IRC 6019).
      - Form 1041 (Federal Income Tax Return).
   d. Fair evaluations of estate assets are performed.
   e. Consideration is given to the effects of the Generation Skipping Tax on distributions to younger generations. (IRC Chapter 13).

9. Proceed to step 9 of Tier I.

The objective of these procedures is to ensure compliance with the fiduciary standards imposed by the Employee Retirement Income Security Act of 1974 (ERISA) and applicable laws. Banks that administer pension, profit-sharing and other such accounts subject to ERISA are liable for violations of the act and for mismanagement of such plans and accounts. The Department of Labor is the primary agency responsible for enforcing provisions of ERISA.

When evaluating this section, the examiner should focus on the effectiveness of the internal control system implemented by the bank to ensure compliance. The testing should be based on work performed by internal/external auditors and/or other internal compliance review units and formalized policies and procedures, and the effectiveness of management information systems.

For substantial deficiencies disclosed in audit/compliance reports, determine whether corrective action has been taken or if not, why not.

Completion of the Employee Benefits Worksheet at the end of this section will assist the examiner in performing these procedures. The worksheet is optional.

Tier I

PROCEDURES

1. Review policies and procedures pertaining to the administration of employee benefit accounts.
2. Determine whether the bank's acceptance and monitoring policies, practices and procedures regarding employee benefit accounts are adequate to screen apparent or potential violations of ERISA or other problems that could conflict with its fiduciary duties and responsibilities.
3. Determine whether the bank monitors transactions adequately to determine whether they involve parties-in-interest, as defined in Section 3(14) of ERISA, directly or indirectly, in the:
   a. Sale, exchange or lease of property. (ERISA Section 406(a)(1)(A))
   b. Lending of money or other extension of credit. (ERISA Section 406(a)(1)(B))
   c. Furnishing of goods, services or facilities. (ERISA Section 406(a)(1)(C))
   d. Transfer to or use of assets by or for the benefit of a party-in-interest. (ERISA Section 406(a)(1)(D))
   e. Dealing with plan assets for their own account or in their own interest. (ERISA Section 406(b)(1))
   f. Acting in any capacity involving a plan on behalf of a party whose interests are adverse to those of the plan, its participants or beneficiaries. (ERISA Section 406(b)(2))
   g. Receiving any considerations for their personal accounts from any party dealing with the plan in connection with a transaction involving plan assets. (ERISA Section 406(b)(3))

   NOTE: Under a 1980 agreement between the OCC and the Department of Labor, the OCC makes referrals of apparent violations of ERISA to that agency. See Section 603.1 of the *Comptroller's Handbook for National Trust Examiners* for referral instructions.
4. Determine whether the bank monitors investments made pursuant to the authorized independent direction of a participant in an individual account plan so that such investments do not contradict the terms of the plan or the regulations of the Secretary of Labor. (ERISA Section 404(c))
5. If the bank invests as directed by a named fiduciary, as expressly provided in the governing instrument, ascertain whether the bank monitors such directions to ensure that they are proper, according to the terms of the plan and not contrary to the provisions of ERISA, particularly as they relate to prudence and diversification.
6. When exercising investment responsibility in the purchase or retention of qualifying employer securities or real estate, determine whether:
   a. The investment is prudent and for the exclusive benefit of participants and beneficiaries. (ERISA Section 404(a)(1)(B))
   b. The aggregate of such holdings by each account which is a defined benefit plan (pension plan), but not an eligible individual account plan, will not exceed 10 percent of the net fair market value of the assets of the plan. (ERISA Section 407(a)(3))
   c. If an eligible individual account plan (profit-sharing, stock bonus, or similar defined contribution plan) holds such assets, the governing instrument provides for their acquisition and holding. (ERISA Section 407(d)(3)(B))
7. Determine that the bank has developed policies and procedures to ensure that loans made to employee benefit trust participants are in compliance with applicable provisions of ERISA and the Internal Revenue Code. (IRC, Section 72(p))
8. If the bank receives any type of remuneration or rebate for investing cash balances, ascertain that such a fee arrangement meets the guidelines established by the Department of Labor.

Employee Stock Ownership Plans (ESOPs)

9. Determine that the bank administers ESOPs in accordance with established Department of Labor and Internal Revenue Service regulations. (29 CFR 2550) (26 CFR 54)

10. Review the results of work performed in Tier I. If the results reflect significant violations and/or control deficiencies, or you are unable to reach a conclusion, perform additional procedures, as necessary, in Tier II.
11. Discuss the following with management:
    a. Violations of law, rulings, regulations or significant internal control deficiencies, emphasizing particularly their causes.
    b. Recommended corrective action for deficiencies cited.
    c. Bank's commitment to specific actions for correcting deficiencies.
12. Summarize your conclusions concerning the bank's policies, procedures and practices relating to the administration of employee benefit accounts. This summary should focus on:
    - Material policy deficiencies.
    - Material internal control weaknesses.
    - Violations of law, rulings and regulations.
13. Update appropriate work programs.

Tier II

Select a sample of accounts that covers all administrators and administrative units to ensure detection of any existing weaknesses or deficiencies.

PROCEDURES

1. Determine whether the bank, as trustee, employs the following procedures in discharging its duties properly:
    a. Makes investments to support the execution of the plan's funding policy. (ERISA Section 402(b)(1))
    b. Diversifies investments of the fund, unless it is clearly prudent not to do so and is excepted under provisions of ERISA, such as investing in qualifying employer securities and real property. (ERISA Section 404(a)(1)(c))
    c. Does not knowingly participate in or conceal a breach of responsibility by a co-fiduciary, including an investment manager. (ERISA Section 405(a)(1))
    d. Does not cause a co-fiduciary to commit a breach because of the bank's failure to comply with the fiduciary duties imposed on it by ERISA. (ERISA Section 405(a)(2))
    e. Makes reasonable efforts to remedy any breach by a co-fiduciary, if it has knowledge of such a breach. (ERISA Section 405(a)(3))
    f. Ascertains that all nonbank parties who handle funds or other property under bank control are bonded. (ERISA Section 412(b))
    g. Prohibits any person known by the bank to have been convicted of specified crimes from serving in a fiduciary or other specified capacity. (ERISA Section 411(a))
    h. Exercises reasonable care when acting as a co-trustee to prevent another co-trustee from committing a breach. (ERISA Section 405(b)(1)(A))

    NOTES: ERISA Section 405—If a governing instrument authorizes an allocation of duties and responsibilities among co-trustees, the bank will not be responsible for any loss to the plan resulting from the co-trustee's acts or omissions arising from the performence of his or her duties and responsibilities, except for breaches of the rules pertaining to co-fiduciaries.

    If the plan provides that assets are to be held in more than one trust, the bank, as trustee, is liable only for an act or omission relating to a trust for which it is trustee.
2. Select a sample of loans to employee benefit trust participants and determine whether such loans are in compliance with applicable provisions of ERISA and the Internal Revenue Code and that:
    a. Loan balances do not exceed the lesser of $50,000 (this $50,000 limit is reduced by the excess of the highest outstanding balance owed by the participant during the prior 12 months) or the greater of 50 percent of a participant's vested interest or $10,000.
    b. The loan is repayable within 5 years except for loans used for the purchase of the participant's principal residence.
    c. Level amortization of the loan is required at least quarterly. (IRC Section 72(p))
    d. Such loans are available to all participants and beneficiaries on a reasonably equivalent basis.
    e. Such loans are made in accordance with specific provisions set forth in the plan.
    f. Such loans bear a reasonable rate of interest.
    g. Such loans are adequately secured. (ERISA Section 408(b)(1))
3. Review delinquent participant loans and determine whether appropriate action is being taken.
4. Ascertain whether the bank's investment data and financial statement analyses indicate that a review is made of the current financial condition and history of a company or its affiliate before purchasing or retaining qualifying employer securities or real estate in order to act within the bounds of prudence and for the exclusive benefit of participants and beneficiaries. (ERISA Section 404)
5. Determine whether the bank certifies within 120

days after the end of a plan's fiscal year, the information required by the plan administrator to publish an annual report, including:

a. Information pertaining to party-in-interest transactions.

b. Reportable transactions exceeding 3 percent of the current value of assets.

c. Past due leases and loans. (ERISA Section 103(a)(2)(B))

Employee Stock Ownership Plans (ESOPs)

6. Select a sample of ESOPs, which were acquired, made distributions to participants, or had investment transactions since the last examination, to test for compliance with applicable laws and regulations. (29 CFR 2550) (26 CFR 54)

The following procedures that refer to sections of 29 CFR 2550 of the Department of Labor are indicated by a single (*) asterisk. Those with a double (**) asterisk refer to 26 CFR 54 of the Internal Revenue Code.

7. Determine whether the bank has a procedure to review with counsel the corporate, securities and tax laws pertaining to the acquisition and distribution of qualifying employer securities (QES) in ESOP accounts.

8. Ascertain whether the bank administers each ESOP in accordance with 29 CFR 2550, Sections 408b-3, 407d-5 and 6 of the Department of Labor and 26 CFR 54, Sections 4975-7, 11 and 12 of the Internal Revenue Code (collectively called The Regulations) only if:

   a. Approved by the IRS.

   b. The governing document:

      - Formally designates the account as an ESOP. (Section 407d-6 (a)(2)*)
      - Allows the plan to invest primarily in QES. (Section 407d-6(b)*)
      - Provides for distribution of principal from the portion of an ESOP consisting of a stock bonus plan only in stock of the employer or cash. (Section 4975-11(f)**)
      - Provides that transactions involving QES are for the primary benefit of participants and their beneficiaries only. (Section 408b-3(b)(2)*) (Section 408b-3(c)*)
      - Does not obligate the plan to acquire securities at an indefinite date (e.g., not upon the death of the holder of the securities). (Section 407d-6(a)(6)*)

9. If QES are acquired with the proceeds of a loan made or guaranteed by a party-in-interest which is to be exempt from the prohibited transaction provisions of ERISA Section 406(a) and (b) excluding subsection 406(b)(3), determine whether the bank monitors transactions so that:

   a. The loan is made at least on the same basis as one between independent parties. (Section 408b-3(c)(3)*)

   b. Loan proceeds are used only to acquire or hold QES or repay a prior exempt loan. (Section 408b-3(d)*)

   c. Plan assets are not drained off because of interest rates or prices of securities. (Section 408b-3(c)(2)*)

   d. The loan is secured only by QES. (Section 408b-3(e)*)

   e. Collateral is released from encumbrance in amounts consistent with The Regulations to avoid plan disqualification. (Section 408b-3(h)*)

   f. Defaults are satisfied by the transfer of plan assets, the values of which do not exceed the amount of the default. (Section 408b-3(f)*)

10. If QES acquired with the proceeds of an exempt loan are not publicly traded, determine whether the governing document requires that:

    a. When distributed, such securities, including those subject to trading limitations, are also subject to a put option (exercisable only by the participant, his or her donees or estate) which meets the requirements of The Regulations as to: (Section 408b-3(j),(k),(l) and (m)*)

       - Value.
       - Time limit.
       - Payment schedule.

    b. If it provides for the right of first refusal by the plan or employer in purchasing equity securities, such transactions are made at the values and within the time limits prescribed by The Regulations. (Section 408b-3(i)*)

11. When transactions involve QES not publicly traded, including those subject to trading limitations, ascertain whether a good faith determination of the securities' fair market value is made:

    a. By an experienced independent appraiser. (Section 4975-11(d)(5)**)

    b. At least annually and as of the transaction date, if it is with a party-in-interest.

    c. By considering any other factors when involving a party-in-interest.

12. Determine that the bank considers whether the governing instrument provides for a method of voting stock held in trust. (Section 409 (A)(e)*).

13. Proceed to step 12 of Tier I.

Tier II

Select corporate trust and agency accounts, both established relationships and new accounts accepted since the last examination.

PROCEDURES

1. Determine whether the bank, in order to fulfill its duties and responsibilities, obtains original or certified copies of:
   a. The governing instrument.
   b. The resolution of the obligor's governing body authorizing the execution of the indenture.
   c. Articles of incorporation and all amendments.
   d. Bylaws and all amendments.
   e. Supporting attorneys' opinions.
   f. The leases supporting industrial revenue bonds, if applicable.
   g. Specimen signatures, which should be updated periodically, of parties signing securities and documents as authorized by resolution of the board of directors or trustees of the obligor.
   h. Specimen bonds in the form adopted by the issuer.
   i. The registration statement and all amendments filed with the SEC, if applicable.
   j. The application for qualification of the indenture and all amendments, under the Trust Indenture Act of 1939, and the bank's statement of eligibility, if applicable. (15 USC 77aaa, et seq.)
   k. Orders of approval or permits of public service commissions or other bodies whose consent is required for the issuance of debt securities, if applicable.
   l. Printers' certificates or copies of receipts documenting amounts of unissued certificates placed in the bank's possession or retained by the bank note company.
   m. Receipts from obligors and underwriters for authenticated securities.
2. Determine whether the bank monitors the obligor's compliance with the governing instrument (through tickler files or otherwise) by verifying:
   a. The payment of interest and principal on the obligation to the trust on a timely basis.
   b. The adequacy of cash received from the obligor to cover debt and other fund payments.
   c. The existence of signed authorizations for directed investments.
   d. The receipt and retention of collateral for the indebtedness, where applicable.
   e. The maintenance of appropriate insurance, where applicable.
   f. The receipt and review of the obligor's annual financial statements, certifications by the obligor or other required documentation.
   g. Independent public accountants' opinions.
   h. That investments are made in accordance with the terms of the indenture or local law.
3. For accounts that must comply with the Trust Indenture Act of 1939, determine whether:
   a. Trustee's reports are filed with security holders, stock exchanges and the SEC. (15 USC 77mmm)
   b. An annual check is made by the bank as of May 15 to verify whether any conflicts of interest exist. The OCC recommends that banks administering such corporate trust accounts perform this check quarterly.
4. Review the opinions of counsel in the account's records and determine whether the following matters were covered:
   a. Organization of the issuer.
   b. Validity of the instruments conveying title to real estate as to execution, filing, recording and documentary stamps.
   c. Sufficiency of assignments, deeds or mortgages, conveying other property or assets as security.
   d. Validity of the issue of bonds or stocks.
   e. Approvals of any commission, body or agency of the state as required by federal and state statutes.
   f. Qualification and registration with the SEC.
   g. Applicability of the Trust Indenture Act of 1939. (15 USC 77aaa, *et seq.*)
5. Determine that the governing instrument clearly defines the duties and responsibilities of the bank for:
   a. Default by the obligor in meeting interest and principal payments, sinking fund and other funding requirements or in maintaining collateral requirements in collateral trusts.
   b. The action to be taken in the event of default.
6. For accounts in which the bank is a successor trustee of a corporate trust issue, determine if the predecessor trustee and the issuer have certified the amount of the issue outstanding.
7. Ascertain if insurance policies required by the governing instrument are held in the custody of the bank and loss payable clauses assign proceeds to the bank as trustee.
8. If securities are authorized and issued pursuant to a supplemental indenture, determine if bank procedures require verification that their issuance complies with the terms of the original instrument.
9. Determine whether the bank's procedures for ad-

ministering corporate trusts provide for:

   a. Recording all account assets and any security underlying a debt issue.
   b. Holding security for collateral trusts:
      - In negotiable form.
      - Under control of the trustee.
      - In type and amount as defined by the trust instrument.
   c. Reconciling each bond issue at least annually.

10. For unclaimed funds held to pay principal and interest, determine if the bank:
    a. Monitors the amounts to ensure that all withdrawals are proper.
    b. Escheats funds to the state as required by local law.
    c. Returns funds to the obligor upon request, if the governing instrument and local law so authorize.

11. Determine that bank procedures for handling bearer bonds in corporate trusts include the requirement that:
    a. The processing of such bonds, upon issuance or redemption, be verified by two or more parties.
    b. Public notification be made of called bonds, if required by the governing instrument.

12. Determine whether the bank's policy is to promptly invest corporate trust cash in short-term investment vehicles when it is not prohibited by the terms of the governing instrument.

13. Ascertain whether the bank obtains estimates of the value of the property from experienced independent engineers or appraisers, who are acceptable to the trustee, before allowing a partial release of property securing a corporate trust issue.

14. Determine that the bank obtains adequate evidence of appointment as paying agent of bond issues for which it has not been named trustee.

15. For paying agencies which deposit funds with the bank, ascertain whether the bank reconciles deposits for the payment of bonds and/or coupons with the amounts due as reflected in maturity schedules.

16. For co-agency relationships, determine if the bank reconciles its record of deposits and disbursements to that of co-paying agents and co-dividend disbursing agents.

17. Determine whether the bank maintains control over checks covering the payment of dividends or registered bond interest which have been returned from the post office.

18. For paying agencies and dividend disbursing agencies, determine whether the bank's procedures provide for escheating unclaimed funds to the state pursuant to local law.

19. Determine that the procedures in effect provide for the proper reconciliation of dividend disbursing agencies at least quarterly.

20. If the bank is named voting trustee, determine if it requires:
    a. Documentation which clearly defines the duties and responsibilities of the bank and the trustors.
    b. That the governing instrument provide that the bank take action only as directed by a designated group of stockholders.

21. If the bank has been designated as corporate depository to hold stocks or bonds of a company in connection with a capital or debt reorganization or foreclosure, determine whether the bank has acted only in accordance with instructions of a shareholders' or bondholders' committee or a trustee in bankruptcy.

22. Proceed to step 9 of Tier I.

This worksheet is intended to assist the examiner in performing the Corporate Trusts and Agencies procedures. It is optional.

Account number ____________________ Account name ____________________

Account officer ____________________ Examination date ____________________

Original amount ____________________ Current balance ____________________

Default provisions? ____ yes ____ no
(section __________ of lease; section __________ of agreement)

Supplemental indenture? ____ yes ____ no
Does it conform to the original agreement? ____ yes ____ no

Registered issue? ____ yes ____ no
Adequate records kept? ____ yes ____ no

Assets and collateral recorded on ledgers? ____ yes ____ no
Sub accounts required? ____________________

Sufficient cash to cover disbursements? ____ yes ____ no

Paid bonds and coupons cancelled properly? ____ yes ____ no

TIA of 1939 applicable? ____ yes ____ no
Trust reports ____________________
Conflicts ____________________

Financial statements required? ____ yes ____ no
Current financial statement on file? ____ yes ____ no
Other financial information required? ____ yes ____ no

Investment provisions:
U.S. govt's/agencies ____________________ Other CD's ____________________
Municipals ____________________ Other ____________________
Own bank CD's ____________________
Do investments conform to provisions in the agreement? ____ yes ____ no

Insurance provisions:

Coverage type	*Amount*	*On File*
Title	____________	____ yes ____ no
Builders' risk	____________	____ yes ____ no
Fire and E.C.	____________	____ yes ____ no
Liability	____________	____ yes ____ no
Workman's comp.	____________	____ yes ____ no
Boiler	____________	____ yes ____ no
____________	____________	____ yes ____ no
____________	____________	____ yes ____ no

Other duties of the trustee: ____________________

COMMENTS:

This checklist is intended to assist the examiner in performing the Corporate Trusts and Agencies procedures. It is optional.

Examination Date		
Issuing Company, Security Description, Account Number		
Governing Instrument		
Board Resolution		
Articles of Incorporation as Amended		
Bylaws and Amendments		
Specimen Bonds		
Specimen Signatures		
Printer's Certification		
Lease (if IDR Bond)		
PSC Approval (if applicable)		
Attorneys' Opinions		
Default Provisions		
Successor Trustee Certification of Amount Outstanding		
TIA of 1939 Application		
Statement of Eligibility		
SEC Registration		
Records of Certificates Received and Issued		

The objectives of these procedures are to determine the adequacy of overall policies, practices and internal controls regarding transfer agent activities and other securityholder services functions; to evaluate compliance with established rules for registered transfer agents pursuant to 17 CFR 240.17Ad 1-14 and other applicable laws; and to determine whether the bank is fulfilling the terms of its agency agreements or other contracts properly.

When evaluating this section, the examiner should focus on the effectiveness of the internal control systems implemented by the bank to ensure compliance. The testing should be based on work performed by internal/external auditors and/or other internal compliance review units and formalized policies and procedures, and the effectiveness of management information systems.

For substantial deficiencies disclosed in audit/compliance reports, ascertain if corrective action has been taken, or if not, why not.

Tier I

PROCEDURES

1. Determine if, prior to accepting transfer agency and registrar accounts, the bank's procedures provide for:
   a. A review of the company's history.
   b. Inquiry about and evaluation of the integrity of company management.
   c. A review of the company's financial condition and an evaluation of its creditworthiness.
   d. A review of the company's securityholder records.
2. For documentation of account records, determine whether the bank's procedures provide for obtaining the original or certified copies of:
   a. Agency agreements which specifically set forth the bank's duties and responsibilities.
   b. The corporate resolution authorizing the appointment.
   c. Specimen certificates in the form adopted by the company and certified by its secretary.
   d. Supporting attorneys' opinion(s).
   e. Specimen signatures of parties signing certificates, as authorized by a certified resolution of the board of directors.
   f. Articles of incorporation and amendments.
   g. Bylaws and amendments.
   h. Orders, approvals or permits of public service commissions or other body whose consent is required for the issuance of securities, if applicable.
   i. Printers' certificates or other documentation evidencing amounts of unissued certificates placed in the bank's possession.
3. When the bank's appointment is for an issue which was previously handled by another transfer agent, ascertain whether the bank has obtained:
   a. A certified list of stockholders showing names, addresses, number of shares owned and certificate numbers.
   b. A list of certificates for which stop orders have been placed.
   c. Appropriate indemnification for any out-of-proof conditions.
4. Determine whether the bank has adequate procedures to guard against over-issuance or under-issuance in its transfer agent operations which include:
   a. The preparation of daily transfer journals recording the name, certificate number and number of shares owned for each certificate cancelled or issued.
   b. Reconciliation of transfer journals on the day of each transaction, including a prompt investigation of any suspense entries or out-of-proof conditions.
   c. An aged schedule, by item, of any errors, suspense entries, or out-of-proof conditions which are subject to periodic management review.
5. Determine if the bank periodically reconciles the shareholder certificate file with the shareholder master control file.
6. Inspect the journal sheets and controls for transfer agencies and determine whether:
   a. The number of shares cancelled and issued are reconciled each transaction day.
   b. The number of shares outstanding are reconciled periodically with the records of the registrar.
   c. Transfers are performed in accordance with established turnaround standards. (17 CFR 240.17Ad-1 to 7)

NOTE: Rule 496 of the New York Stock Exchange and Rule 891 of the American Stock Exchange permit:

- Out-of-town transfer agents to act in lieu of New York City agents if they provide for:
  —A normal 48-hour transfer cycle.
  —An adequate and completely staffed office or "drop" in New York City even though the bulk of the clerical work may be performed and the records maintained at an out-of-town location.
- Qualified independent banks to act, in a dual capacity, as transfer agents/registrars for a listed security if they provide for:
  —The financial and insurance requirements of each rule.

—Appropriate controls, subject to review by the bank's independent auditors.

7. For compliance with the Securities Exchange Act of 1934—17 CFR 240, ascertain whether the bank's procedures require: (DS.VII-23, 24)
   a. The turnaround and processing of at least 90 percent of the routine items received during a month within: (17 CFR 240.17Ad-2)
      - Three business days for transfer accounts.
      - One business day for registrar accounts.
   b. Filing a notice with the OCC and SEC within 10 business days after the end of the month if the bank does not meet the turnaround and processing requirements of Rule 17Ad-2, including written notice of the number of items unprocessed or not turned around, the reason for the failure, and steps being taken to prevent recurrence. (17 CFR 240.17Ad-2)

      NOTE: A bank is exempt from complying with requirements of Rule 17Ad-2, if during any consecutive 6-month period, it has received less than 500 items for transfer or for processing as registrar and has prepared a notice of exemption to be maintained among its records.
   c. A limitation on expansion of transfer agency activities whenever the turnaround requirements are not met. (17 CFR 240.17Ad-3)
   d. Responses to written inquiries and requests regarding the status of items presented for transfer come within the following time frames: (17 CFR 240.17Ad-5)
      - Five business days concerning the status of an open item.
      - Ten business days for confirmation of certificate possession.
      - Twenty business days to make available a transcript of the shareholder's account.
   e. Maintenance and retention of transfer and turnaround records. (17 CFR 240.17Ad-6 and 7)
   f. The establishment of minimum standards for the prompt and accurate creation and maintenance of issuer securityholder records. (17 CFR 240.17Ad-10)
   g. The reporting of serious difficulties in the performance of transfer agent functions to regulatory authorities and securities issuers. (17 CFR 240.17Ad-11)
   h. That securities or funds in its custody or possession are held in safekeeping and handled in a manner reasonably free from risk of destruction, theft or other loss, considering the cost of various safeguards and procedures, and the degree of potential financial exposure. (17 CFR 240.17Ad-12)

8. Determine whether the bank's procedures also provide for:
   a. Obtaining adequate insurance for its transfer agency activities.
   b. Requiring necessary documentation to accompany certificates presented for transfer, such as guarantee of owner's signature and required legal documentation.
   c. Controlling dormant funds.

9. Determine whether the bank submits:
   a. Form 1099 pertaining to dividends and interest paid securityholders to the Internal Revenue Service.
   b. Information pertaining to personal property or other taxes, as required, to state taxing authorities.

10. For compliance with the Securities Exchange Act of 1934, determine whether the bank's procedures provide for:
    a. Filing Form TA-1 pursuant to Sections 17, 17A and 23A of the 1934 Act and 12 CFR 9.20, when required.
    b. Filing Form TA-2 annually pursuant to Rule 17Ac2-2, when required.
    c. Promptly correcting differences in its transfer agent operations.
    d. Fingerprinting directors, officers and employees involved in or with access to transfer agent activities pursuant to SEC Rule 17(f)(2), including personnel assigned such duties since the preceding examination.
    e. Maintaining appropriate records of fingerprinting, as required by SEC Rule 17(f)(2)(d).

    Coordinate this procedure with the examiner assigned to perform the Regulatory Reports program.

11. Review the results of work performed in Tier I. If the results reflect significant violations and/or control deficiencies or you are unable to reach a conclusion, perform additional procedures, as necessary, in Tier II.

12. Discuss the following with management:
    a. Violations of law, rulings, regulations or significant internal control deficiencies, emphasizing particularly their causes.
    b. Recommended corrective action for deficiencies cited.
    c. Bank's commitment to specific actions for correcting deficiencies.

13. Summarize your conclusions concerning the bank's policies, procedures and practices relating to securityholder services. This summary should focus on:
    - Material policy deficiencies.

- Material internal control weaknesses.
- Violations of law, rulings and regulations.

14. Update appropriate work programs.

Tier II

PROCEDURES

1. If the bank acts as transfer agent for mutual funds, determine whether it requires that:
    a. Funds received by the bank as a shareholder agent/custodian be posted to the fund records within 24 hours of receipt. (Investment Company Act of 1940, Section 2(a)(41))
    b. Daily reconciliation of all cash and related accounts (purchase, redemption, dealer commission, etc.) be made to ensure that all items have been properly reflected on the shareholder accounting system.
    c. Periodic reconciliation of fund balances be made to records maintained by the fund bookkeeper or portfolio custodian.
2. If the bank maintains a FAST position with a depository, determine that procedures require a daily reconciliation of depository balance confirmation reports.
3. When the bank acts as registrar for an issue, determine if the bank's procedures:
    a. Ensure that the aggregate number of new shares issued is equal to the number of shares represented by the cancelled certificates.
    b. Provide for periodic verification that the aggregate shares outstanding do not exceed the total authorized by the issuing companies' articles of incorporation and board resolutions.
4. When the bank acts as registrar and transfer agent of the same issue, determine whether the bank's procedures provide for each being independently reconciled on the day of each transaction and that the procedures comply with Rules 496 of the NYSE and 891 of Amex, when applicable.
5. If the bank acts as fund custodian or fund bookkeeper for a mutual fund, ascertain whether the procedures require:
    a. Periodic reconciliation of uninvested cash, dividend accounts and suspense accounts.
    b. Review of account overdrafts.
    c. Review of the timeliness and accuracy of securities settlement and posting procedures to ensure the reliability of net asset value calculations.
6. If the bank acts as dividend disbursing agent, determine whether procedures require that:
    a. Dividend and interest paying accounts be balanced against the shareholder accounts prior to disbursement.
    b. Outstanding balances in dividend or interest paying accounts, including dividend or interest payments returned from the post office, be reconciled periodically.
    c. Stop payment notices be reviewed prior to dividend or interest disbursement.
    d. Unclaimed funds be escheated to the state pursuant to local law.
7. If the bank acts as dividend reinvestment agent, ascertain if procedures require:
    a. The maintenance of written authorizations from all shareholders participating in the dividend reinvestment program.
    b. A documented policy governing the time and method of purchasing shares used in the program.
8. When acting as exchange agent (tender agent), determine whether there are procedures to control and reconcile the receipt and re-issuance of certificates. (17 CFR 240.17Ad-14)
9. If the bank is named subscription agent, determine whether it requires documentation to define its duties and responsibilities.
10. Proceed to step 12 of Tier I.

The objectives of these procedures are to determine the adequacy of the bank's policies, procedures, and internal controls as they relate to conflict of interest and self-dealing situations. The most fundamental duty a fiduciary has to beneficiaries is loyalty. A fiduciary is not permitted to place itself in a position where its interest comes before that of the beneficiaries. A fiduciary must administer accounts solely in their best interests.

When evaluating this section, the examiner should focus on the effectiveness of the internal control systems implemented by the bank to ensure compliance. The testing should be based on work performed by internal/external auditors and/or other internal compliance review units and formalized policies and procedures, and the effectiveness of management information systems.

For substantial deficiencies disclosed in audit/compliance reports, ascertain if corrective action has been taken, or if not, why not.

Tier I

PROCEDURES

1. Review the adequacy of the bank's policies and procedures regarding conflicts of interest and self-dealing by determining whether:
   a. They are comprehensive, clear and in accordance with laws and regulations.
   b. There is a system for compliance monitoring.
2. Determine whether the bank has a written code of ethics and that all fiduciary personnel properly acknowledge reading it and abiding with its terms. The code of ethics should include, but not be limited to:
   a. Serving as co-fiduciary with the bank for a fee. (12 CFR 9.15(b))
   b. Receiving loans from fiduciary clients.
   c. Accepting gifts and bequests from fiduciary clients.
   d. Engaging in activities in competition with the bank or in conflict with fiduciary interests.
3. Determine that the bank conducts educational programs for personnel to foster awareness of the importance of avoiding both the appearance of conflict and actual abuses.
4. Determine the effectiveness of the bank's system for identifying potential conflicts. The system should provide the information listed in step 5 to appropriate fiduciary personnel when they screen transactions that may involve conflicts of interest or self-dealing. (12 CFR 9.12)
5. Obtain the information that the bank uses in its monitoring system and review it for accuracy by referring to appropriate sources, such as annual financial statements of the bank and its affiliates. Compile lists of such individuals and companies and retain them in the permanent files of the working papers for future examinations. The information should include: (12 CFR 9.12)
   a. Names of directors and principal bank officers.
   b. Names of affiliates, their directors and principal officers, and the nature of the affiliations.
   c. Names of organizations related to the bank, such as other banks that have directors in common and a degree of common ownership; and the names of the organizations' directors and principal officers, and the nature of the relationships.
   d. Business interests of directors and principal officers of the bank and its affiliates and those listed in SEC Form 10-K concerning bank holding companies.
   e. Names of principal stockholders (5 percent and over) of the bank and its affiliates, excluding directors and principal officers.
   f. Names of other individuals with whom the bank has a relationship that may affect the exercise of its best judgment, such as advisory or honorary directors and directors emeriti. The list should also include those persons with whom the bank conducts significant amounts of business, such as real estate brokers, agents and appraisers, securities brokers, legal and investment advisors, insurance agents and brokers, and the companies with which such individuals are affiliated.

   NOTE: Examiners reviewing transactions of individual accounts in other examination sections, such as Portfolio Management and the administration of Employee Benefit Accounts, also should refer to the information listed in this step to determine if transactions involve conflicts of interest or self-dealing.
6. Determine whether there is an internal monitoring system to ensure that the following have been purchased, retained or sold only with lawful authorization of the governing instrument, court order or local law: (12 CFR 9.12)
   a. Own bank, holding company and affiliate:
      - [illegible] debentures and obligations.
      - Interest bearing time or demand deposits.
      - Repurchase and reverse repurchase agreements. (TBC-22)
   b. Stock and obligations of other organizations in which there exists a relationship that may affect the exercise of the bank's best judgment, such as companies in which directors or officers of the bank, its affiliates or related organizations hold an interest.
   c. Obligations of directors, officers and employees of the bank, and directors and principal officers of its affiliates and related organizations.

NOTE: Terms of the governing instrument and local law, notwithstanding, loans to directors, officers, or employees are prohibited by 12 USC 92a(h).

7. If the bank does not maintain documentation for monitoring conflicts of interest, obtain lists of fiduciary account holdings listed in step 6 and determine if the holdings are properly authorized. Judgmental sampling may be used for such assets. (12 CFR 9.12)
8. Review proxies or lists of shares voted to determine whether the bank has complied with 12 USC 61 in voting own bank stock and with local law in voting shares of own bank holding company stock for the election of directors. For companies in which directors, officers or employees or other organizations have an interest which might affect the exercise of the best judgment of the bank, determine whether the bank has a policy of evaluating the best interests of beneficiaries in determining proxy voting decisions.
9. If the bank or an affiliate has been a member of a syndicate engaged in the sale of debt securities or has advised or assisted in a private placement, obtain or prepare lists of all such syndicates and private placements since *(select date)* and determine whether: (TBC-19) (12 USC 371c)
   a. Fiduciary investment personnel were notified of the bank's participation in such securities activities.
   b. Any such securities were purchased by a fiduciary account:
      - When originally issued from a member of a syndicate, or parties involved in making a private placement.
      - From an intermediate party, within 60 days of the original sale.

   NOTE: If the former, such transactions violate 12 CFR 9.12; if the latter, there may have been an attempted evasion of that section. Also refer to Section 23B of Federal Reserve Act.
10. Ascertain whether the bank utilizes an affiliate discount brokerage company for effecting securities transactions for fiduciary accounts and determine whether:
    a. Such transactions should be performed on a non-profit basis pursuant to TBC-23.
    b. Accounts subject to ERISA conform to the appropriate standards of that act. The use of an affiliate discount broker would appear to be a prohibited transaction with a party-in-interest.
11. Obtain or prepare a list of all companies or individuals to whom money is loaned by accounts in which the bank exercises investment responsibility, and determine whether the proceeds of any loan made by an account were used to pay any loan to the bank. (12 CFR 9.12)
12. Obtain or prepare a list of all debt securities issued by companies, in which bank directors and principal officers hold an interest, that are also held in accounts for which the bank has investment responsibilities. Determine whether the proceeds of any purchased security were used to pay off any loan by the commercial department to the issuer or to retire any securities of the issuer held by the commercial department. Examiners should check the prospectus or other memoranda of a security issue to ascertain the purpose for which the proceeds were to be used.
13. Refer to the list of recently accepted corporate bond trusteeships and determine whether the proceeds of such obligations were used to retire loans to the bank in full or in part.
14. Obtain or prepare a list of bank directors, officers, employees and other insiders who receive fee concessions from the established fee schedule for fiduciary services and determine whether such fee concessions comply with the bank's written pricing policy and management's profitability objectives. (TBC-13 (Rev))
15. Evaluate the adequacy of procedures and monitoring systems designed to prevent conflicts of interest and self-dealing by the bank as fiduciary, in terms of:
    a. Using non-public information in making investment decisions. (12 CFR 9.7(d))
    b. Complying with the provisions of 12 CFR 9, local law and the governing instrument regarding:
       - Selling assets held by it as fiduciary in one account to itself as fiduciary in another account. (12 CFR 9.12(d))
       - Making a loan to an account from funds belonging to another account. (12 CFR 9.12(e))
       - Making loans to fiduciary accounts from the bank or its affiliates. (12 CFR 9.12(f))
16. Discuss the following with management:
    a. Violations of law, rulings, regulations or significant internal control deficiencies, emphasizing particularly their causes.
    b. Recommended corrective action for deficiencies cited.
    c. Bank's commitment to specific actions for correcting deficiencies.
17. Summarize your conclusions about the bank's policies, procedures and practices regarding fiduciary conflict of interest and self-dealing. This summary should focus on:
    - Material policy deficiencies.
    - Material internal control weaknesses.
    - Violations of laws, rulings and regulations.
18. Update appropriate work programs.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM TIMOTHY RYAN

Office of Thrift Supervision
Department of the Treasury

Timothy Ryan
Director

1700 G Street, N.W., Washington, D.C. 20552 • (202) 906-6280

August 10, 1990

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing and
  Urban Affairs
United States Senate
Washington, D.C. 20510-6075

Dear Chairman Riegle:

The following are my responses to questions you asked concerning the June 21, 1990 hearing on the issue: "Is there a Credit Crunch?"

Q. 1. There are numerous complaints that commercial banks have raised their credit standards and cut back their lending in New England. Do you hear the same complaints in the S&L industry, in general, and in New England, in particular?

A. 1. In general, we have heard sporadic comments, mainly from builders and developers, concerning the availability of credit to complete or refinance existing projects. Most of these comments center around the impact that the more rigid loans to one borrower restrictions under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 have had on their operations. The comments do not appear to indicate that there has been an internal tightening of credit standards among thrift institutions.

To date, the number of complaints received from the New England area have not exceeded those from other geographic locations throughout the United States.

Q. 2. Do you expect the situation for thrifts in New England to become as serious as it was in the Southwest?

A. 2. Although it is true that both New England and Southwest area thrifts experienced regional economic downturns that have adversely affected their operations, I do not expect the situation to become as serious in New England as it was in the Southwest. We are not witnessing the high levels of mismanagement, fraud, and insider dealing in New England that occurred at many Southwest area thrift institutions which directly contributed to the size of their losses.

Sincerely,

Timothy Ryan

Timothy Ryan
Director

STATEMENT OF
ROBERT A. MOSBACHER
DEPARTMENT OF COMMERCE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

JUNE 21, 1990

CREDIT CONDITIONS AND INTERNATIONAL COMPETITIVENESS

This statement expresses my personal views on the increasing difficulties by small and medium sized firms in obtaining credit. This statement was prepared at the request of the Chairman of the Senate Banking Committee at my hearing on U.S. competitiveness on June 14.

Credit conditions in the United States have tightened in recent months, placing financial pressures on many businesses and especially in the real estate industry. In the first quarter of 1990, net borrowing by nonfinancial business was 20 percent below the year-earlier level, according to Federal Reserve flow-of-funds data.

While real estate lending has been especially slow this year, other lending has also been reduced. Banks have tightened lending by increasing collateral requirements or shortening loan terms. According to Federal Reserve reports, large Federal Reserve banks on June 6, 1990, had $322 billion in commercial and industrial loans outstanding, practically unchanged since the beginning of the year.

Especially hard-hit have been small and medium sized businesses since these businesses tend to rely heavily on bank loans for their financing. These businesses include many small producers of the technologically advanced products and services that are of growing importance to our international competitiveness. Many, but not all, of these high-tech businesses are located in the New England area where the credit crunch has been most pronounced. But while the credit problem differs by region, it appears to be national in scope.

Over the longer term, the international competitive strength of the U.S. economy depends on our productive capacity. The small businesses that rely heavily on bank financing to meet their financial requirements to add capacity will have particular difficulty in responding to the international challenge during times when credit is tight.

Compared with firms based in Japan and certain other countries that have been investing relatively high shares of their gross national product in the production of new plant and equipment, U.S. firms have long suffered a disadvantage in terms of the cost of capital. According to a study published by the Federal Reserve Board of New York, the cost of capital for investment in equipment and machinery with physical life of 20 years was about 400 basis points higher in 1988 in the United States than in Japan or Germany.

In the case of research and development projects with a 10-year payoff lag, the U.S. cost-of-capital disadvantage in 1988 was found to be 1160 basis points compared with Japan and 550 basis points compared with Germany. Although capital costs in Japan have risen in the past year, recent credit restraints in the United States may be making this problem more serious for small and medium sized U.S. firms.

Because investment tends to be highly responsive to general business conditions, an economic slowdown brought about by restrictive credit conditions can be expected to restrain total growth in spending on plant and equipment and thus limit our international competitive strength.

Lack of credit affects our ability to export. Since U.S. capacity utilization in manufacturing is running at about 83 percent, we need long-term credit to expand capacity for exporting.

To continue to expand exports, U.S. business must add to its productive capacity and increase efficiency in those industrial sectors in which the United States enjoys potentially strong competitive advantages. A credit-market-induced slowdown in investment would be very undesirable at this time when the need to improve our international competitiveness and the opportunity to do so are both so great. In 1989, U.S. economic growth was heavily dependent on exports of goods and services, accounting for nearly half of total GNP growth. The important role that exports is playing in enhancing productivity growth and employment is clearly indisputable.

One example flushes out the evidence of surveys which I will discuss later, illustrating the credit-market-induced investment slowdown. Although the MidWest has not been experiencing as much wide-spread credit availability problems, credit has become tighter over the last year or so according to Mr. Lee Berlin, Chairman of the Minnesota District Export Council and Chairman of the Governor's Committee on Medical Manufacturing. (Mr. Berlin is President of LECTEC, a high tech medical manufacturing company that makes artificial skin, skin electrodes and other medical devices.)

Our firms need substantial credit in order to invest to meet the new challenges they face abroad. Of particular importance in this respect are the challenges resulting from the reduction in market restrictions in Eastern and Western Europe, Southeast Asia, and in Latin America.

Mr. Berlin noted that "money has tightened up, particularly for acquisitions and capacity expansion." Small medical companies (there are 500 in Minnesota), constituting one of the fastest growing manufacturing segments, "can't get loans for expansion". His assessment is that this could impede growth just as Eastern European and Soviet markets, that desperately need medical supplies and manufacturing capability, begin to open up as an area of high growth potential in this important sector for U. S. manufacturing.

Other specific examples of the U.S. credit crunch are emerging and becoming nationwide in scope:

– a survey by the Private Companies Practices Section (PCPS) of the American Institute of Certified Public Accountants found that fully one third of the small businesses interviewed were being squeezed by the credit crunch;

– about 30 percent of the banks in a new Federal Reserve survey said that in the past six months they had trimmed the size of credit lines to businesses with annual sales of $50 million to $250 million.

I appreciate the opportunity to express my personal views on this very important topic, and look forward to working with the Committee in the future on issues affecting the competitiveness of U.S. business.

naiop
National Association of Industrial and Office Parks

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Telephone: 703/979-3400 • FAX: 703/979-3409

July 19, 1990

The Honorable Donald W. Riegle, Jr.
Banking, Housing and Urban Affairs Committee
United States Senate
Dirksen Senate Office Building
Room 534
Washington, D.C. 20510
Attn: Edward Malen

Dear Chairman Riegle:

The National Association of Industrial and Office Parks (NAIOP) respectfully submits the following comments regarding its concerns on the effects of an apparent credit crunch developing throughout the country.

Contrary to the opinions voiced by several prominent Washington policy makers, there is evidence of a severe credit crunch moving throughout the country. Credit restrictions and restructurings are resulting in projects being stopped, construction workers being laid off, and entire enterprises being put in jeopardy. This is a result, not of a failure to meet immediate loan terms, but of a fear that at some time in the future the borrower may not be able to meet his obligations. Such over reaction not only places tremendous burdens on existing projects, but may actually induce further decline in the marketplace.

A recent study conducted by retail developers has determined a 25 percent decline in defined commercial development starts for the first quarter of 1990. This decline occurred while economic indicators of demand were increasing. NAIOP is witnessing similar evidence across the country and throughout the commercial real estate industry.

The NAIOP urges commercial bankers to continue to make loans to proven, credit worthy borrowers, based on reasonable and equitable standards. The NAIOP also urges the Administration and the Congress to take whatever actions are necessary to alleviate the current credit crunch before it infects the entire economy and causes severe economic problems throughout the nation.

The National Association of Industrial and Office Parks (NAIOP) represents over 7,000 commercial real estate developers and associated professionals throughout the United States, Canada, and Puerto Rico. The NAIOP membership is responsible for over 90 percent of the commercial real estate development within the United States. The association is dedicated to promoting responsible and effective public policy, association member education, and improvement of the quality of life in all communities.

Thank you for your consideration.

Sincerely,

Frank D. Visceglia
President